

SCHNITZER STEEL INDUSTRIES INC  
Form 10-Q/A  
August 30, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q/A  
Amendment No. 1

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended February 28, 2006 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 0-22496

**SCHNITZER STEEL INDUSTRIES, INC.**  
(Exact name of registrant as specified in its charter)

**OREGON**  
(State or other jurisdiction of  
incorporation or organization)

**93-0341923**  
(I.R.S. Employer  
Identification No.)

**3200 N.W. Yeon Ave.**  
**P.O Box 10047**  
**Portland, OR**  
(Address of principal executive offices)

**97296-0047**  
(Zip Code)

**(503) 224-9900**  
(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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The Registrant had 22,618,709 shares of Class A Common Stock, par value of \$1.00 per share, and 7,985,366 shares of Class B Common Stock, par value of \$1.00 per share, outstanding at March 31, 2006.

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EXPLANATORY NOTE

This Form 10-Q/A amends the Quarterly Report on Form 10-Q that was originally filed on April 10, 2006 (the “Original Form 10-Q”) by Schnitzer Steel Industries, Inc. (the “Company”) for the quarterly period ended February 28, 2006. The Company identified errors related to the application of purchase accounting and the reporting of cash flows. Accordingly, this Form 10-Q/A:

- restates the Company’s condensed consolidated statements of operations and consolidated statements of cash flows for the six months ended February 28, 2006 and related disclosures;
- discloses the determination that as of February 28, 2006, material weaknesses existed in the Company’s internal control over financial reporting related to the application of purchase accounting and reporting of cash flows;
- discloses that due to the aforementioned material weaknesses as of the quarter ended February 28, 2006 the Company’s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended, (the “Exchange Act”)) and disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as discussed under Item 4 were not effective.

The revised assessment and determination relating to the Company’s disclosure control and procedures and a description of the changes in internal control over financial reporting are included herein under Part 1, Item 4.

No attempt has been made in this amendment to modify or update disclosures presented in the Original Form 10-Q, except with respect to the foregoing and certain enhancements in disclosure included in Part I. Accordingly, this amendment on Form 10-Q/A should be read in conjunction with the Company’s filings made with the Securities and Exchange Commission (the “SEC”) subsequent to the filing of the Original Form 10-Q, including any amendments to these filings.

In addition, this amendment on Form 10-Q/A includes currently dated Sarbanes-Oxley Act Section 302 and Section 906 certifications of the Chief Executive Officer and Chief Financial Officer, attached hereto as Exhibits 31.1, 31.2, 32.1 and 32.2.

The aforementioned restatement corrects an error relating to the interpretation and application of generally accepted accounting principles as related to purchase accounting. During the three months ended November 30, 2005, as a result of a separation and termination agreement with Hugo Neu Corporation (“HNC”), the Company acquired the assets of Prolerized New England Company and Subsidiaries (“PNE”), Hugo Neu Schnitzer Global Trade-Baltic Operations (“HNSGT-Baltic”), and THS Recycling LLC, dba Hawaii Metal Recycling Company (“HMR”). Additionally, during the three months ending November 30, 2005, the Company acquired the assets of Regional Recycling, LLC (“Regional”) and purchased GreenLeaf Auto Recyclers, LLC (“GreenLeaf”). In the condensed consolidated statements of operations for the three months ended November 30, 2005 included in the Company’s Original Form 10-Q, the Company accounted for the operations of all of the acquired businesses on a consolidated basis as of the beginning of the Company’s fiscal year 2006 (September 1, 2005) with a corresponding deduction for the pre-acquisition operating results in arriving at net income. In addition, an error related to the application of purchase accounting affected the statement of cash flows. The cash flow from the Company’s investments in Regional, HMR, Greenleaf, PNE and HNSGT-Baltic were classified as cash flow from operations in error. The restatement corrects these errors in purchase accounting for acquisitions and reclassifies the cash received as a result of the acquisitions as net cash (used) provided by investments.

During the third quarter ending May 31, 2006, management began reevaluating the accounting treatment for the acquisitions that occurred during the first quarter fiscal 2006. Through the reevaluation, it was determined that the acquired entities in which the Company did not have a previous equity interest, HMR, Regional and GreenLeaf, were accounted for incorrectly in the Company's condensed consolidated statements of operations for the three months ended November 30, 2005 included in the Company's Original Form 10-Q. ARB 51 allows the results of operations of entities acquired through a "step" acquisition to be consolidated as of the beginning of the fiscal year or as of the date of the acquisition. If the results of operations are consolidated as of the beginning of the fiscal year, there must be an offset for the pre-acquisition interests prior to arriving at net income. As the Company had prior joint venture interests in PNE and HNSGT-Baltic, the acquisitions of PNE and HNSGT-Baltic were each "step" acquisitions and the Company's consolidation of their operations as of the beginning of fiscal year 2006 was appropriate. However, as the Company did not have a previous interest in HMR, Regional, and GreenLeaf the acquisitions of HMR, Regional and GreenLeaf were not "step" acquisitions and their results of operations should have only been consolidated as of the respective dates of acquisition.

The restatement also corrects an error relating to the application of purchase accounting, which affected the consolidated statements of cash flows. Cash acquired from the Company's investments in Regional, HMR, Greenleaf, PNE and HNSGT-Baltic was classified as net cash provided by operations in error. This restatement corrects these errors and reclassifies the cash proceeds as a result of the acquisitions as net cash (used) provided by investments. The restatement of the statement of cash flows affects minority interest, accrued liabilities, equity in income of joint ventures and other assets and liabilities.

Lastly, the restatement corrects an error in classification with respect to cash flows received from its interests in joint ventures. Previously, the Company considered certain cash flows received from its joint ventures as returns of its investment and had therefore classified these cash flows as investing activities. However, the Company has subsequently determined that these cash flows should have been considered a return on investment and classified as an operating activity as distributed/(undistributed) equity in earnings of joint ventures. Additionally, the Company has corrected its presentation of changes in other assets and changes in other liabilities within the cash flows from operating activities section and proceeds from line of credit, repayments of line of credit, proceeds from long-term debt, and repayments of long-term debt, within the cash flows from financing activities section of the consolidated statements of cash flows, to reflect these items gross rather than net. These errors did not impact the Company's consolidated statements of operations or consolidated statements of shareholders' equity for the quarter ended February 28, 2006 and February 28, 2005, nor did it have an impact on the consolidated balance sheets as of February 28, 2006 and February 28, 2005.



SCHNITZER STEEL INDUSTRIES, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited, in thousands)

	Feb 28, 2006	Aug. 31, 2005
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ 34,185	\$ 20,645
Accounts receivable, less allowance for doubtful accounts of \$1,160 and \$810	113,876	51,101
Accounts receivable from related parties	216	226
Inventories	185,196	106,189
Deferred income taxes	6,234	3,247
Prepaid expenses and other	10,925	15,505
Total current assets	350,632	196,913
Property, plant and equipment, net	268,035	166,901
Other assets:		
Investment in and advances to joint venture partnerships	7,835	184,151
Notes receivable, less current portion	3,731	1,234
Goodwill	258,604	151,354
Intangibles and other assets	6,440	8,905
	\$ 895,277	\$ 709,458
<u>Liabilities and Shareholders' Equity</u>		
Current liabilities:		
Current portion of long-term debt	\$ 106	\$ 71
Accounts payable	53,065	33,192
Accrued payroll liabilities	19,880	21,783
Current portion of environmental liabilities	6,586	7,542
Accrued income taxes	6,593	140
Other accrued liabilities	33,433	8,307
Total current liabilities	119,663	71,035
Deferred income taxes	1,681	26,987
Long-term debt, less current portion	77,924	7,724
Environmental liabilities, net of current portion	38,483	15,962
Other long-term liabilities	2,803	3,578
Minority interests	9,534	4,644
Commitments and contingencies	—	—
Shareholders' equity:		

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Preferred stock--20,000 shares authorized, none issued	—	—
Class A common stock--75,000 shares \$1 par value authorized, 22,606 and 22,490 shares issued and outstanding	22,606	22,490
Class B common stock--25,000 shares \$1 par value authorized, 7,986 shares issued and outstanding	7,986	7,986
Additional paid-in capital	129,728	125,845
Retained earnings	484,788	423,178
Accumulated other comprehensive income:		
Foreign currency translation adjustments	81	29
Total shareholders' equity	645,189	579,528
	\$ 895,277	\$ 709,458

The accompanying notes to the unaudited condensed consolidated financial statements  
are an integral part of these statements.



SCHNITZER STEEL INDUSTRIES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited, in thousands, except per share amounts)

	For The Three Months Ended February 28,		For The Six Months Ended February 28,	
	2006	2005	2006 (as restated)	2005
Revenues	\$ 403,285	\$ 215,746	\$ 744,516	\$ 414,707
Operating expenses:				
Cost of goods sold	338,561	155,041	623,667	294,481
Selling, general and administrative	33,540	13,172	73,884	25,410
Environmental matter	—	7,725	—	8,225
Income from wholly-owned operations	31,184	39,808	46,965	86,591
Income from joint ventures	386	16,205	2,138	36,669
Operating income	31,570	56,013	49,103	123,260
Other income (expense):				
Interest expense	(401)	(346)	(836)	(630)
Other income, net	689	368	56,223	279
	288	22	55,387	(351)
Income before income taxes and minority interests	31,858	56,035	104,490	122,909
Income tax provision	(10,591)	(19,500)	(41,726)	(42,772)
Income before minority interests	21,267	36,535	62,764	80,137
Minority interests, net of tax	(149)	(554)	(302)	(1,220)
Pre-acquisition interests, net of tax	—	—	186	—
Net income	\$ 21,118	\$ 35,981	\$ 62,648	\$ 78,917
Net income per share - basic:	\$ 0.69	\$ 1.18	\$ 2.05	\$ 2.60
Net income per share - diluted:	\$ 0.68	\$ 1.15	\$ 2.03	\$ 2.53

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of these statements.

SCHNITZER STEEL INDUSTRIES, INC.  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(Unaudited, in thousands)

	Class A		Class B		Additional Paid-in Capital	Retained Earnings	Accumulated	Total
	Common Shares	Stock Amount	Common Shares	Stock Amount			Other Comprehensive Income	
Balance at August 31, 2004	22,022	\$ 22,022	8,306	\$ 8,306	\$ 110,177	\$ 278,374	1	\$ 418,880
Net income						146,867		146,867
Foreign currency translation adjustment							28	28
Comprehensive income								146,895
Class B common stock converted to Class A common stock	320	320	(320)	(320)				—
Class A common stock issued	148	148			1,511			1,659
Tax benefits from stock options exercised					14,157			14,157
Cash dividends paid - common (\$0.068 per share)						(2,063)		(2,063)
Balance at August 31, 2005	22,490	22,490	7,986	7,986	125,845	423,178	29	579,528
Net income						62,648		62,648
Foreign currency translation adjustment							52	52
Comprehensive income								62,700
Stock-based compensation					2,513			2,513
Class A common stock issued	116	116			738			854
Tax benefits from stock options exercised					632			632
Cash dividends paid - common (\$0.034 per share)						(1,038)		(1,038)
Balance at February 28, 2006	22,606	\$ 22,606	7,986	\$ 7,986	\$ 129,728	\$ 484,788	81	\$ 645,189

The accompanying notes to the unaudited condensed consolidated financial statements  
are an integral part of these statements.

SCHNITZER STEEL INDUSTRIES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited, in thousands)

	For The Six Months Ended	
	February 28, 2006 (as restated)	February 28, 2005 (as restated)
Cash flows from operating activities:		
Net income	\$ 62,648	\$ 78,917
Noncash items included in income:		
Depreciation and amortization	13,992	10,143
Minority interests and pre-acquisition interests	476	1,874
Deferred income tax	(10,846)	—
Distributed/(undistributed) equity in earnings of joint ventures	15,797	3,381
Stock-based compensation expense	1,415	—
Excess tax benefit from stock options exercised	(632)	14,376
Gain on disposition of joint venture assets	(54,618)	183
Gain on disposal of assets	277	—
Changes in assets and liabilities:		
Accounts receivable	14,315	(21,557)
Inventories	18,719	(10,851)
Prepaid expenses and other current assets	13,757	(4,939)
Other assets	310	18
Accounts payable	(16,264)	653
Accrued liabilities	5,078	(7,347)
Environmental liabilities	(3,266)	633
Other liabilities	(909)	234
Net cash provided by operating activities	60,249	65,718
Cash flows from investing activities:		
Capital expenditures	(37,466)	(15,221)
Acquisitions, net of cash acquired	(76,722)	—
Investment in subsidiaries	—	(22,176)
Cash paid to joint ventures	(790)	(851)
Proceeds from sale of assets	19	495
Net cash used in investing activities	(114,959)	(37,753)
Cash flows from financing activities:		
Proceeds from line of credit	69,000	89,600
Repayment of line of credit	(69,000)	(79,600)
Proceeds from long-term debt	184,232	114,100
Repayment of long-term debt	(114,000)	(144,218)
Issuance of Class A common stock	854	1,258
Excess tax benefit from stock options exercised	632	—
Distributions to minority interests	(2,430)	(2,113)
Dividends declared and paid	(1,038)	(1,028)
Net cash provided (used) by financing	68,250	(22,001)

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Net increase in cash and cash equivalents	13,540	5,964
Cash and cash equivalents at beginning of period	20,645	11,307
Cash and cash equivalents at end of period	\$ 34,185	\$ 17,271

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of these statements.

SCHNITZER STEEL INDUSTRIES, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED FEBRUARY 28, 2006 AND 2005

**Note 1 - Restatement:**

The condensed consolidated statements of operations for the six months ended February 28, 2006 have been restated due to the following:

The restatement corrects errors related to the application of purchase accounting and the reporting of cash flows. During the three months ended November 30, 2005, as a result of a separation and termination agreement with Hugo Neu Corporation (“HNC”), the Company acquired the assets of Prolerized New England Company and Subsidiaries (“PNE”), Hugo Neu Schnitzer Global Trade-Baltic Operations (“HNSGT-Baltic”), and THS Recycling LLC, dba Hawaii Metal Recycling Company (“HMR”). Additionally, during the three months ended November 30, 2005, the Company acquired the assets of Regional Recycling, LLC (“Regional”) and purchased GreenLeaf Auto Recyclers, LLC (“GreenLeaf”). In the condensed consolidated statements of operations for the six months ended February 28, 2006, included in the Company’s Original Form 10-Q, the Company accounted for the operations of all of the acquired businesses on a consolidated basis, as of the beginning of the Company’s fiscal year 2006, with a corresponding deduction for the pre-acquisition operating results in arriving at net income.

It was determined that the acquired entities in which the Company did not have a previous interest, HMR, Regional and GreenLeaf, were accounted for incorrectly in the Company’s condensed consolidated statements of operations for the six months ended February 28, 2006 included in the Company’s Original Form 10-Q. ARB 51 allows the results of operations of entities acquired through a “step” acquisition to be consolidated as of the beginning of the fiscal year or as of the date of the acquisition. If the results of operations are consolidated as of the beginning of the fiscal year, there must be an offset for the pre-acquisition interests prior to arriving at net income. As the Company had prior joint venture interests in PNE and HNSGT-Baltic, the acquisitions of PNE and HNSGT-Baltic were each “step” acquisitions and the Company’s decision to consolidate their operations as of the beginning of fiscal year 2006 was appropriate. However, as the Company did not have a previous interest in HMR, Regional, and GreenLeaf, these acquisitions under the provisions of SFAS 141 were not “step” acquisitions and their results of operations should have been consolidated as of the relevant dates of acquisition.

While the error did not impact net income or net income per share, it did result in the misstatement of a number of line items in the condensed consolidated statements of operations for the six months ended February 28, 2006, as presented. The error had no impact on the condensed consolidated balance sheets as of February 28, 2006 or the consolidated statements of cash flows for the six months ended February 28, 2006.

SCHNITZER STEEL INDUSTRIES, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED FEBRUARY 28, 2006 AND 2005

A summary of the restatements included in the condensed consolidated statements of operations in this amended filing are:

	As Previously Reported	Adjustment	As Restated
<i>Statement of Operations for the six months ended February 28, 2006</i>			
Revenue	\$ 791,958	\$ (47,442)	\$ 744,516
Cost of goods sold	662,174	(38,507)	623,667
Selling, general and administrative	78,627	(4,743)	73,884
Interest expense	(1,382)	546	(836)
Other income, net	65,130	(8,907)	56,223
Income tax provision	(46,148)	4,422	(41,726)
Pre-acquisition interests, net of tax	(7,945)	8,131	186
Net income	62,648	—	62,648

Additionally, as a result of the error in purchase accounting, cash acquired from the Company's investments in Regional, HMR, Greenleaf, PNE and HNSGT-Baltic was classified as net cash provided by operations in error. This restatement corrects this error and reclassifies the cash acquired as a result of the acquisitions as net cash (used) provided by investments. The restatement of the consolidated statements of cash flows affects the minority interest, accrued liabilities, equity in income of joint ventures and other assets and liabilities line items in the consolidated statements of cash flows.

Finally, the consolidated statements of cash flows for the quarters ended February 28, 2006 and February 28, 2005 have been restated to correct an error in the classification of cash flows received from its interest in joint ventures. The Company had previously considered cash flows received from its joint ventures as returns of its investment and had therefore classified these cash flows as investing activities. However, the Company has now determined that the cash flows from its joint ventures should have been considered a return on its investment and classified as an operating activity as distributed/(undistributed) equity in earnings of joint ventures. The restatement does not affect net income or earnings per share and did not have an impact on the Company's consolidated statements of operations or consolidated statements of shareholders' equity for the quarters ended February 28, 2006 and February 28, 2005, nor did it have an impact on the consolidated balance sheets as of February 28, 2006 and February 28, 2005. Additionally, the Company has corrected its presentation of changes in other assets and changes in other liabilities within the cash flows from operating activities section and proceeds from line of credit, repayments of line of credit, proceeds from long-term debt, and repayments of long-term debt, within the cash flows from financing activities section of the consolidated statements of cash flows, to reflect these items gross rather than net.

SCHNITZER STEEL INDUSTRIES, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED FEBRUARY 28, 2006 AND 2005

Restated consolidated statements of cash flows for all affected periods reflecting the aforementioned adjustments are presented below (amounts in thousands):

	For the Six Months Ended February 28, 2006		
	As reported	Adjustment	As restated
Cash flows from operating activities:			
Net income	\$ 62,648	\$ —	\$ 62,648
Noncash items included in net income:			
Depreciation and amortization	13,992	—	13,992
Minority and pre-acquisition interests	906	(430)	476
Deferred income taxes	(10,847)	1	(10,846)
Distributed/(undistributed) equity in earnings of joint ventures	(1,401)	17,198	15,797
Stock based compensation expense	1,415	—	1,415
Excess tax benefit from stock options exercised	—	(632)	(632)
Gain on disposition of joint venture assets	(54,341)	(277)	(54,618)
Gain on disposal of assets	—	277	277
Changes in assets and liabilities:			
Accounts receivable	14,537	(222)	14,315
Inventories	17,909	810	18,719
Prepaid expenses and other current assets	13,413	344	13,757
Other assets	—	310	310
Accounts payable	(16,264)	—	(16,264)
Accrued liabilities	11,169	(6,091)	5,078
Environmental liabilities	(3,267)	1	(3,266)
Other liabilities	—	(909)	(909)
Other assets and liabilities	3,264	(3,264)	—
Net cash provided by operating activities	53,133	7,116	60,249
Cash flows from investing activities:			
Capital expenditures	(37,465)	(1)	(37,466)
Acquisitions, net of cash acquired	(87,746)	11,024	(76,722)
Cash received from joint ventures	18,147	(18,147)	—
Cash paid to joint ventures	(626)	(164)	(790)
Proceeds from sale of assets	19	—	19
Net cash used in investing activities	(107,671)	(7,288)	(114,959)
Cash flows from financing activities:			
Proceeds from line of credit	—	69,000	69,000
Repayment of line of credit	—	(69,000)	(69,000)
Proceeds from long-term debt	—	184,232	184,232
Repayment of long-term debt	—	(114,000)	(114,000)
Issuance of Class A common stock	854	—	854
Excess tax benefit from stock options exercised	632	—	632
Distributions to minority interests	(2,603)	173	(2,430)



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Dividends declared and paid	(1,038)	—	(1,038)
Increase (decrease) in long-term debt	70,233	(70,233)	—
Net cash provided by financing activities	68,078	172	68,250
Net increase in cash	13,540	—	13,540
Cash at beginning of period	20,645	—	20,645
Cash at end of period	\$ 34,185	\$ —	\$ 34,185

SCHNITZER STEEL INDUSTRIES, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED FEBRUARY 28, 2006 AND 2005

	For the Six Months Ended February 28, 2005		
	As reported	Adjustment	As restated
Cash flows from operating activities:			
Net income	\$ 78,917	\$ —	\$ 78,917
Noncash items included in net income:			
Depreciation and amortization	10,143	—	10,143
Minority and pre-acquisition interests	1,874	—	1,874
Distributed/(undistributed) equity in earnings of joint ventures	(36,669)	40,050	3,381
Excess tax benefit from stock options exercised	14,376	—	14,376
Gain on disposition of joint venture assets	183	—	183
Changes in assets and liabilities:			
Accounts receivable	(21,557)	—	(21,557)
Inventories	(10,851)	—	(10,851)
Prepaid expenses and other current assets	(4,939)	—	(4,939)
Other assets	—	18	18
Accounts payable	653	—	653
Accrued liabilities	(7,347)	—	(7,347)
Environmental liabilities	633	—	633
Other liabilities	—	234	234
Other assets and liabilities	252	(252)	—
Net cash provided by operating activities	25,668	40,050	65,718
Cash flows from investing activities:			
Capital expenditures	(15,221)	—	(15,221)
Investment in subsidiaries	(22,176)	—	(22,176)
Cash received from joint ventures	40,050	(40,050)	—
Cash paid to joint ventures	(851)	—	(851)
Proceeds from sale of assets	495	—	495
Net cash provided by investing activities	2,297	(40,050)	(37,753)
Cash flows from financing activities:			
Proceeds from line of credit	—	89,600	89,600
Repayment of line of credit	—	(79,600)	(79,600)
Proceeds from long-term debt	—	114,100	114,100
Repayment of long-term debt	—	(144,218)	(144,218)
Issuance of Class A common stock	1,258	—	1,258
Distributions to minority interests	(2,113)	—	(2,113)
Dividends declared and paid	(1,028)	—	(1,028)
Increase (decrease) in long-term debt	(20,118)	20,118	—
Net cash used in financing activities	(22,001)	—	(22,001)
Net increase in cash	5,964	—	5,964
Cash at beginning of period	11,307	—	11,307

Cash at end of period	\$	17,271	\$	—	\$	17,271
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SCHNITZER STEEL INDUSTRIES, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE SIX MONTHS ENDED FEBRUARY 28, 2006 AND 2005

**Note 2 - Summary of Significant Accounting Policies:**

*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements of Schnitzer Steel Industries, Inc. (the "Company") have been prepared pursuant to generally accepted accounting principles and the rules and regulations of the Securities Exchange Commission ("SEC"). The year-end condensed consolidated balance sheets data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. Certain information and note disclosures normally included in annual financial statements have been condensed or omitted pursuant to those rules and regulations. In the opinion of management, all adjustments, consisting only of normal, recurring adjustments considered necessary for a fair presentation, have been included. Although management believes that the disclosures made are adequate to ensure that the information presented is not misleading, management suggests that these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's annual report for the fiscal year ended August 31, 2005. The results for the three and six months ended February 28, 2006 and 2005 are not necessarily indicative of the results of operations for the entire year.

*Reclassifications*

Certain prior year amounts have been reclassified to conform to the current year presentation. These changes had no impact on previously reported results of operations or shareholders' equity.

*Cash and Cash Equivalents*

Cash and cash equivalents include short-term securities that are not restricted by third parties and have an original maturity date of 90 days or less. Included in accounts payable are book overdrafts of \$12.4 million and \$11.5 million as of February 28, 2006 and August 31, 2005, respectively.

*Net Income and Dividends per Share*

Basic net income per share is computed based upon the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock. All of the options issued through and outstanding as of February 28, 2006, except for 155,900 shares granted on November 29, 2005, are considered to be dilutive.

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The following represents the reconciliation from basic net income per share to diluted net income per share (in thousands, except per share amounts):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
Net income	\$ 21,118	\$ 35,981	\$ 62,648	\$ 78,917
Computation of shares:				
Average common shares outstanding	30,528	30,422	30,503	30,386
Stock options	329	773	351	784
Diluted average common shares outstanding	30,857	31,195	30,854	31,170
Basic net income per share	\$ 0.69	\$ 1.18	\$ 2.05	\$ 2.60
Diluted net income per share	\$ 0.68	\$ 1.15	\$ 2.03	\$ 2.53
Dividend per share	\$ 0.017	\$ 0.017	\$ 0.034	\$ 0.034

Goodwill and Intangible Assets

The changes in the carrying amount of goodwill for the six months ended February 28, 2006 are as follows (in thousands):

	Metals Recycling Business	Auto Parts Business	Total
Balance as of August 31, 2005	\$ 34,771	\$ 116,583	\$ 151,354
Acquisition of GreenLeaf Auto Recyclers, LLC (see Note 4)	—	9,122	9,122
Separation and termination of joint venture relationships with Hugo Neu Corporation (see Note 4)	61,633	—	61,633
Acquisition of Regional Recycling LLC assets (see Note 4)	36,495	—	36,495
Balance as of February 28, 2006	\$ 132,899	\$ 125,705	\$ 258,604

The Company performs impairment tests annually during the second quarter of the fiscal year and whenever events and circumstances indicate that the value of goodwill and other indefinite-lived intangible assets might be impaired. Based on the operating results of each of the businesses identified above and the Company's impairment testing completed in the second quarter of fiscal 2006, the Company determined that none of the above balances were considered impaired.

Foreign Currency Transactions

The Company uses derivative instruments (foreign currency forward contracts) to manage exposures to foreign currency translation gains and losses. Although those forward contracts are not designated as hedging instruments under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," they are used to hedge the impact of the variability in exchange rates on accounts receivable and collections denominated in foreign currencies. The accounts receivable and derivative instrument used to hedge the foreign-currency

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denominated assets are measured at fair value, with changes in fair value recognized immediately in earnings as a transaction gain or loss, in accordance with SFAS No. 52, "Foreign Currency Translation." As of February 28, 2006, the aggregate of transaction gains and losses was immaterial to the financial statements taken as a whole.

New Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, "Inventory Costs." This statement clarifies the accounting for abnormal amounts of idle facility expense and freight and handling costs when those costs may be so abnormal as to require treatment as period charges. This statement is effective for fiscal years beginning after June 15, 2005. The Company adopted SFAS No. 151 on September 1, 2005 with no material impact on the consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets." This statement explains that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. This statement is effective for fiscal years beginning after June 15, 2005. The Company adopted SFAS No. 153 on September 1, 2005 with no material impact on the consolidated financial statements.

In December 2004, the FASB finalized SFAS No. 123(R) "Share-Based Payment," which became effective as of the first interim reporting period of the first fiscal year beginning after June 15, 2005. The new standard requires the Company to expense stock options beginning in the first quarter of fiscal 2006. The Company adopted SFAS No. 123(R), effective September 1, 2005. SFAS No. 123(R) requires the recognition of the fair value of stock-based compensation in net income. The Company recognizes stock-based compensation expense over the requisite service period of the individual grants, which generally equals the vesting period. See Note 8 to the condensed consolidated financial statements for further information regarding stock-based compensation.

In June 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." This statement revises the reporting requirements related to changes in accounting principles or adoption of new accounting pronouncements. This statement is effective for fiscal years beginning after December 15, 2005. The Company intends to adopt this pronouncement for fiscal year 2007 and does not anticipate this pronouncement to have a material impact on the consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," which is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. This Statement amends FASB Statements No. 133, "Accounting for Derivative Instruments and Hedging Activities" and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." The Company intends to adopt this pronouncement for fiscal year 2007 and does not anticipate this pronouncement to have a material impact on the consolidated financial statements.

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**Note 3 - Inventories:**

Inventories consisted of the following (in thousands):

	February 28, 2006	August 31, 2005
Recycled metals	\$ 102,412	\$ 38,027
Work in process	10,185	17,124
Finished goods	56,941	36,304
Supplies	15,658	14,734
	\$ 185,196	\$ 106,189

**Note 4 - Business Combinations:***Hugo Neu Corporation Separation and Termination Agreement*

On September 30, 2005, the Company, HNC and certain of their subsidiaries closed a transaction to separate and terminate their metals recycling joint venture relationships. The Company received the following as a result of the HNC joint venture separation and termination:

- The assets and related liabilities of Hugo Neu Schnitzer Global Trade related to a trading business in parts of Russia and the Baltic region, including Poland, Denmark, Finland, Norway and Sweden, and a non-compete agreement from HNC that bars it from buying scrap metal in certain areas in Russia and the Baltic region for a five-year period ending on June 8, 2010;
- The joint ventures' various interests in the Northeast operations that primarily operate in Massachusetts, New Hampshire, Rhode Island and Maine;
  - Full ownership in the Hawaii metals recycling business that was previously owned 100% by HNC;
  - A payment of \$36.6 million in cash, net of debt paid, subject to post-closing adjustments.

HNC received the following as a result of the HNC joint venture separation and termination:

- The joint venture operations in New York, New Jersey and California, including the scrap processing facilities, marine terminals and related ancillary satellite sites, the interim New York City recycling contract, and other miscellaneous assets;
- The assets and related liabilities of Hugo Neu Schnitzer Global Trade that are not related to the Russian and Baltic region trading business.

The agreement provides for potential purchase price adjustments based on the closing date working capital of the acquired Hawaii business as well as the joint ventures' ending balances. The Company is in the process of determining whether any purchase price adjustments are necessary.

In accordance with SFAS No. 141, "Business Combinations," the purchase price of the assets acquired and liabilities assumed under the separation and termination agreement is the fair value of the joint venture interests given up as part of the exchange as well as other liabilities assumed and acquisition costs, net of cash received. As a result, the purchase price is estimated to be \$165.1 million.

The purchase price was allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on an estimate of the respective fair values. Final valuation reports are pending from a third party. The excess of the aggregate purchase price over the fair value of the identifiable net assets acquired of approximately \$57.8 million was recognized as goodwill. Approximately \$3.8 million of goodwill existed on the joint ventures' balance sheets prior to



the separation and termination but was not shown separately in accordance with the equity method of accounting. Therefore, the total increase to goodwill related to the HNC Separation and Termination Agreement was \$61.6 million.

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The purchase price allocation has been prepared on a preliminary basis, and reasonable changes are expected as additional information, such as final valuation reports and any purchase price adjustments, becomes available. The following is a summary of the estimated fair values as of February 28, 2006, for the assets acquired and liabilities assumed as of the date of the acquisition (in millions):

Cash, net of debt paid	\$	36.6
Property, plant and equipment		26.1
Inventory		34.9
Other assets		30.3
Identified intangible assets		3.0
Liabilities		(23.6)
Goodwill		57.8
Total purchase price	\$	165.1

GreenLeaf Acquisition

On September 30, 2005, the Company acquired GreenLeaf, five properties previously leased by GreenLeaf and certain GreenLeaf debt obligations. GreenLeaf is engaged in the business of auto dismantling and recycling, and sells its products primarily to collision and mechanical repair shops. GreenLeaf currently operates in three wholesale sales offices and 15 commercial locations throughout the United States. Total purchase price for the acquisition, including acquisition costs, was \$44.5 million, subject to post-closing adjustments.

The purchase price of the GreenLeaf acquisition was allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on an estimate of fair value. The excess of the aggregate purchase price over the estimated fair value of the identifiable net assets acquired of \$9.1 million was recognized as goodwill.

The purchase price allocation has been prepared on a preliminary basis, and reasonable changes are expected as additional information becomes available, such as final valuation reports and any post-closing adjustments. In the second quarter of fiscal 2006, goodwill was reduced for deferred tax assets accompanying the stock acquisition of GreenLeaf. The following is a summary of the estimated fair values as of February 28, 2006, for the assets acquired and liabilities assumed on the date of the acquisition (in millions):

Property, plant and equipment	\$	14.6
Inventory		20.7
Other assets		24.6
Liabilities		(24.5)
Goodwill		9.1
Total purchase price	\$	44.5

Regional Recycling Acquisition

On October 31, 2005, the Company purchased substantially all of the assets of Regional for \$65.5 million in cash and the assumption of certain liabilities, a working capital adjustment of \$2.9 million and acquisition costs of approximately \$0.5 million. Regional operates ten metals recycling facilities located in the states of Georgia and Alabama which process ferrous and nonferrous scrap metals without the use of shredders.

The purchase price of the Regional acquisition was allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on an estimate of the respective fair values. Final valuation reports are pending from an

independent third party. The excess of the aggregate purchase price over the estimated fair value of the identifiable net assets acquired of approximately \$36.5 million was recognized as goodwill.

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The purchase price allocation has been prepared on a preliminary basis, and reasonable changes are expected as additional information becomes available, such as final valuation reports. The following is a summary of the estimated fair values as of February 28, 2006, for the assets acquired and liabilities assumed as of the date of the acquisition (in millions):

Property, plant and equipment	\$	10.6
Accounts Receivable		27.7
Inventory		4.9
Other assets		1.1
Liabilities		(11.9)
Goodwill		36.5
Total purchase price	\$	68.9

Summary of Acquisitions

The total aggregate goodwill recognized from the recent acquisitions amounted to \$103.4 million. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized and will be tested for impairment at least annually. Goodwill recognized in connection with the HNC separation and termination and the Regional acquisition is deductible for tax, whereas that recognized in connection with GreenLeaf, an acquisition of equity interests, is not. Payment of the consideration for the recently acquired businesses was funded by the Company's existing cash balances and credit facility.

The Company recorded a gain of \$54.6 million related to the disposition of assets pursuant to the HNC separation and termination in the first quarter of fiscal 2006. The transaction, which included selling certain assets previously owned through the joint venture, was recorded using the fair value of the assets with consideration of business valuations performed by a third party. The fair value of net assets received exceeded the carrying value of the assets sold, resulting in the gain recorded. Any change to the fair value in the final independent third party valuations would directly impact the gain recorded.

In connection with the HNC separation and termination, and the GreenLeaf and Regional acquisitions, the Company conducted environmental due diligence reviews of the acquired assets. Based upon the information obtained in the reviews in the first quarter of fiscal 2006, in conjunction with purchase accounting, the Company accrued \$24.8 million in environmental liabilities for probable and reasonably estimable future remediation costs at the acquired facilities. During the second quarter of fiscal 2006, the Company incurred remediation costs of \$0.6 million related to these acquired companies. No environmental proceedings are pending with respect to any of these facilities.

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The following table is prepared on a pro forma basis, for the three and six month periods ended February 28, 2006 and 2005, respectively, as though all of the businesses acquired through the HNC separation and termination agreement and GreenLeaf and Regional acquisitions had occurred as of the beginning of the periods presented (in thousands, except per share amounts).

	For the Three Months Ended		For the Six Months Ended	
	February 28,		February 28,	
	2006	2005	2006	2005
Gross revenues	\$ 403,285	\$ 489,486	\$ 791,958	\$ 930,347
Net income	\$ 21,118	\$ 52,172	\$ 70,593 <sup>(1)</sup>	\$ 100,851
Net income per share:				
Basic	\$ 0.69	\$ 1.71	\$ 2.31	\$ 3.32
Diluted	\$ 0.68	\$ 1.67	\$ 2.29	\$ 3.24

<sup>(1)</sup>A tax affected gain of \$33.9 million related to the HNC separation and termination agreement and a \$5.6 million tax affected gain related to the debt extinguishment associated with the GreenLeaf acquisition are included in the pro forma results for the six months ended February 28, 2006.

The pro forma results are not necessarily indicative of what would have occurred if the acquisitions had been in effect for the periods presented. In addition, the pro forma results are not intended to be a projection of future results and do not reflect any synergies that might be achieved from combining operations.

#### **Note 5 - Environmental Liabilities and Other Contingencies:**

The Company considers various factors when estimating its environmental liabilities. Adjustments to the liabilities are made when additional information becomes available that affects the estimated costs to study or remediate any environmental issues. The factors which the Company considers in its recognition and measurement of environmental liabilities include the following:

- Current regulations, both at the time the reserve is established and during the course of the remediation, which specify standards for acceptable remediation;
  - Information about the site that becomes available as the site is studied and remediated;
- The professional judgment of both senior-level internal staff and external consultants, who take into account similar, recent instances of environmental remediation issues, among other considerations;
  - Available technologies that can be used for remediation; and
- The number and financial condition of other potentially responsible parties and the extent of their responsibility for the remediation.

#### **Metals Recycling Business**

In connection with acquisitions in the Metals Recycling Business in 1995 and 1996, the Company carried over to its financial statements reserves for environmental liabilities previously recorded by the acquired companies. These reserves are evaluated quarterly according to Company policy. On February 28, 2006, environmental reserves for the Metals Recycling Business aggregated \$26.4 million.

**Hylebos Waterway Remediation.** General Metals of Tacoma (GMT), a subsidiary of the Company, owns and operates a metals recycling facility located in the State of Washington on the Hylebos Waterway, a part of Commencement

Bay, which is the subject of an ongoing remediation project by the United States Environmental Protection Agency (EPA) under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). GMT and more than 60 other parties were named potentially responsible parties (PRPs) for the investigation and clean-up of contaminated sediment along the Hylebos Waterway. On March 25, 2002, EPA

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issued Unilateral Administrative Orders (UAOs) to GMT and another party (Other Party) to proceed with Remedial Design and Remedial Action (RD/RA) for the head of the Hylebos and to two other parties to proceed with the RD/RA for the balance of the waterway. The UAO for the head of the Hylebos Waterway was converted to a voluntary consent decree in 2004, pursuant to which GMT and the Other Party agreed to remediate the head of the Hylebos Waterway.

There are two phases to the remediation of the head of the Hylebos Waterway. The first phase was the intertidal and bank remediation, which was conducted in 2003 and early 2004. The second phase is dredging in the head of the Hylebos Waterway, which commenced in July 2005 and was completed in February 2006. During fiscal 2005, the Company paid remediation costs of \$15.9 million related to Hylebos dredging which resulted in a reduction of the recorded environmental liability. The Company's cost estimates were based on the assumption that dredge removal of contaminated sediments would be accomplished within one dredge season during July 2004 - February 2005. However, due to a variety of factors, including dredge contractor operational issues and other dredge related delays, the dredging was not completed during the first dredge season. As a result, the Company recorded environmental charges of \$13.5 million in fiscal 2005 primarily to account for additional estimated costs to complete this work during a second dredging season, and the total reserve for this site was \$10.6 million at August 31, 2005. In the second quarter of fiscal 2006 and for the six months ended February 28, 2006, the Company incurred remediation costs of \$0.1 million and \$4.0 million, respectively, which were charged to the environmental reserves, and on February 28, 2006, environmental reserves for the Hylebos Waterway aggregated \$6.6 million. The Company and the Other Party have filed a complaint in the United States District Court for the Western District of Washington against the dredge contractor to recover damages and a significant portion of the increased costs incurred in the second dredging season to complete the project.

GMT and the Other Party are pursuing settlement negotiations and legal actions against other non-settling, non-performing PRPs to recover additional amounts that may be applied against the head of the Hylebos remediation costs. During fiscal 2005, the Company recovered \$0.7 million from four non-performing PRPs. This amount had previously been taken into account as a reduction in the Company's reserve for environmental liabilities. Uncertainties continue to exist regarding the total cost to remediate this site as well as the Company's share of those costs; nevertheless, the Company's estimate of its liabilities related to this site is based on information currently available.

The Natural Resource Damage Trustees (Trustees) for Commencement Bay have asserted claims against GMT and other PRPs within the Hylebos Waterway area for alleged damage to natural resources. In March 2002, the Trustees delivered a draft settlement proposal to GMT and others in which the Trustees suggested a methodology for resolving the dispute, but did not indicate any proposed damages or cost amounts. In June 2002, GMT responded to the Trustees' draft settlement proposal with various corrections and other comments, as did twenty other participants. In February 2004, GMT submitted a settlement proposal to the Trustees for a complete settlement of Natural Resource Damage liability for the GMT site. The proposal included three primary components: (1) an offer to perform a habitat restoration project; (2) reimbursement of Trustee past assessment costs; and (3) payment of Trustee oversight costs. The agreement would also address liability sub-allocation to other parties historically associated with the facility. In December 2005 the Trustees responded to the GMT proposal. The parties are continuing negotiations. The Company's previously recorded environmental liabilities include an estimate of the Company's potential liability for these claims.

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**Portland Harbor.** In December 2000, the United States Environmental Protection Agency (EPA) named the Portland Harbor, a 5.5 mile stretch of the Willamette River in Portland, Oregon, as a Superfund site. The Company's metals recycling and deep water terminal facility in Portland, Oregon is located adjacent to the Portland Harbor. Crawford Street Corporation (CSC), a Company subsidiary, also owns property adjacent to the Portland Harbor. The EPA has identified 69 PRPs, including the Company and CSC, which own or operate sites adjacent to the Portland Harbor Superfund site. The precise nature and extent of any clean-up of the Portland Harbor, the parties to be involved, the process to be followed for such a clean-up, and the allocation of any costs for the clean-up among responsible parties have not yet been determined. It is unclear whether or to what extent the Company or CSC will be liable for environmental costs or damages associated with the Superfund site. It is also unclear whether or to what extent natural resource damage claims or third party contribution or damages claims will be asserted against the Company. While the Company and CSC participated in certain preliminary Portland Harbor study efforts, they are not parties to the consent order entered into by the EPA with other PRPs (Lower Willamette Group) for a Remedial Investigation/Feasibility Study (RI/FS); however, the Company and CSC could become liable for a share of the costs of this study at a later stage of the proceedings.

Separately, the Oregon Department of Environmental Quality (DEQ) has requested operating history and other information from numerous persons and entities which own or conduct operations on properties adjacent to or upland from the Portland Harbor, including the Company and CSC. The DEQ investigations at the Company and CSC sites are focused on controlling any current releases of contaminants into the Willamette River. The Company has agreed to a voluntary Remedial Investigation/Source Control effort with the DEQ regarding its Portland, Oregon deep water terminal facility and the site owned by CSC. DEQ identified these sites as potential sources of contaminants that could be released into the Willamette River. The Company believes that improvements in the operations at these sites, often referred to as Best Management Practices (BMPs), will provide effective source control and avoid the release of contaminants from these sites and has proposed to DEQ the implementation of BMPs as the resolution of this investigation.

The cost of the investigations associated with these properties and the cost of employment of source control BMPs are not expected to be material. No estimate is currently possible, and no liability has been recorded for the remediation for the Portland Harbor.

**Other Metals Recycling Business Sites.** For a number of years prior to the Company's 1996 acquisition of Proler International Corp. (Proler), Proler operated a shredder with an on-site industrial waste landfill in Texas, which Proler utilized to dispose of auto shredder residue (ASR) from the operations. In August 2002, Proler entered the Texas Commission on Environmental Quality (TCEQ) Voluntary Cleanup Program (VCP) toward the pursuit of a VCP Certificate of Completion for the former landfill site. In fiscal 2005, TCEQ issued a Conditional Certificate of Completion, requiring the Company to perform on-going groundwater monitoring and annual inspections, maintenance, and reporting. As a result of the resolution of this issue, the Company reduced its reserve related to this site by \$1.6 million in fiscal 2005.

During the second quarter of fiscal 2005, in connection with the negotiation of the separation and termination agreement relating to the Company's metals recycling joint ventures with HNC (see Note 4), the Company conducted an environmental due diligence investigation of certain joint venture businesses it proposed to acquire. As a result of this investigation, the Company identified certain environmental risks and accrued \$2.6 million for its share of the estimated costs to remediate these risks upon completion of the separation, which was included in the consolidated statements of operations in fiscal 2005. During the first quarter of fiscal 2006, an additional \$12.8 million was recorded, in conjunction with purchase accounting, representing the remaining portion of the environmental liabilities



associated with the separation and termination agreement as well as the Regional acquisition of which \$0.6 million was expended in remediation efforts. No environmental proceedings are pending with respect to any of these sites.

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The Washington State Department of Ecology named GMT, along with a number of other parties, as Potentially Liable Parties (PLPs) for a site referred to as Tacoma Metals. GMT operated on this site under a lease prior until 1982. The property owner and current operator have taken the lead role in performing a Remedial Investigation and Feasibility Study (RI/FS) for the site. The Company's previously recorded environmental liabilities include an estimate of the Company's potential liability at this site.

A Company subsidiary is also a named PRP at another third-party site at which it allegedly disposed of automobile shredder residue. The site has not yet been subject to significant remedial investigation. In addition to the matters discussed above, the Company's environmental reserve includes amounts for potential future cleanup of other sites at which the Company or its acquired subsidiaries have conducted business or allegedly disposed of other materials.

#### **Auto Parts Business**

From fiscal 2003 through the first quarter of fiscal 2006, the Company completed four acquisitions of businesses in the Auto Parts Business segment. At the time of each acquisition, the Company conducted an environmental due diligence investigation related to locations involved in the acquisition. As a result of the environmental due diligence investigations, the Company recorded a reserve for the estimated cost to address certain environmental matters. The reserve is evaluated quarterly according to the Company policy. On February 28, 2006, environmental reserves for the Auto Parts Business aggregated \$18.7 million, which includes an environmental reserve for the GreenLeaf acquisition. No environmental proceedings are pending with respect to any of these sites.

#### **Other Contingencies**

The Company had a past practice of making improper payments to the purchasing managers of customers in Asia in connection with export sales of recycled ferrous metals. The Company stopped this practice after it was advised in 2004 that it raised questions of possible violations of U.S. and foreign laws. Thereafter, the Audit Committee was advised and conducted a preliminary compliance review. On November 18, 2004, on the recommendation of the Audit Committee, the Board of Directors authorized the Audit Committee to engage independent counsel and conduct a thorough, independent investigation. The Board of Directors also authorized and directed that the existence and the results of the investigation be voluntarily reported to the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), and that the Company cooperate fully with those agencies. The Audit Committee notified the DOJ and the SEC of the independent investigation, engaged outside counsel to assist in the independent investigation, and instructed outside counsel to fully cooperate with the DOJ and the SEC and to provide those agencies with the information obtained as a result of the independent investigation. On August 23, 2005, the Company received from the SEC a formal order of investigation related to the independent investigation. The Audit Committee is continuing its independent investigation. The Company, including the Audit Committee, continues to cooperate fully with the DOJ and the SEC. The investigations of the Audit Committee, the DOJ and the SEC of the Company's past practice of making improper payments are not expected to affect the Company's previously reported financial results. However, the Company expects to enter into agreements with the DOJ and the SEC to resolve the above-referenced matters and believes that it is probable that the DOJ and SEC will impose penalties on, and require disgorgement of certain profits by, the Company as a result of their investigations. The Company estimates that the total amount of these penalties and disgorgement will be within a range of \$11.0 million to \$15.0 million. In the first fiscal quarter of 2006, the Company established a reserve totaling \$11.0 million in connection with this estimate. The precise terms of any agreements to be entered into with the DOJ and the SEC, however, remain under discussion with these two agencies. The Company, therefore, cannot predict with certainty the final outcome of the aforementioned investigations or whether the Company or any of its employees will be subject to any additional remedial actions following completion of these investigations.



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**Note 6 - Long Term Debt:**

On November 8, 2005, the Company entered into an amended and restated unsecured committed bank credit agreement with Bank of America, N.A., as administrative agent, and the other lenders party thereto. The agreement provides for a five-year, \$400.0 million revolving credit facility loan maturing in November 2010. The agreement prior to restatement provided for a \$150.0 million revolving credit facility maturing in May 2006. Interest on outstanding indebtedness under the restated agreement is based, at the Company's option, on either LIBOR plus a spread of between 0.625% and 1.25%, with the amount of the spread based on a pricing grid tied to the Company's leverage ratio, or the greater of the prime rate or the federal funds rate plus 0.50%. In addition, annual commitment fees are payable on the unused portion of the credit facility at rates between 0.15% and 0.25% based on a pricing grid tied to the Company's leverage ratio. The restated agreement contains various representations and warranties, events of default and financial and other covenants, including covenants requiring maintenance of a minimum fixed charge coverage ratio and a maximum leverage ratio. As of February 28, 2006, the Company had borrowings outstanding under its Bank of America, N.A. credit facility of \$70.0 million and was in compliance with the representations, warranties and covenants therein. The Company also has an additional unsecured credit line, which was increased on March 1, 2006 by \$5.0 million to \$15.0 million. Interest on outstanding indebtedness is set by the bank at the time of borrowing. This additional debt agreement, which is uncommitted, also has certain restrictive covenants. As of February 28, 2006, the Company had no amounts outstanding under this credit facility. The fair value of long-term debt is deemed to be the same as that reflected in the condensed consolidated balance sheets given the variable interest rates.

**Note 7 - Related Party Transactions:**

The Company leases its administrative offices under operating leases from Schnitzer Investment Corp. (SIC), a Schnitzer family controlled business engaged in real estate. The current leases expire in 2013, and annual rent was \$0.4 million in fiscal 2005. Lease amendments have been executed under which, upon completion of tenant improvements, one lease will be terminated; the premises leased under the other lease will be increased; annual rent will accordingly increase to \$0.5 million; and the lease term will be extended to 2015.

The Company and SIC are parties to a shared services agreement. Starting in fiscal 2005 and continuing into fiscal 2006, the Company has reduced or ceased the sharing of administrative services with SIC and other Schnitzer family companies in a number of areas as part of a process expected to eliminate substantially all the sharing of services between the Company and SIC in fiscal 2006. All transactions with the Schnitzer family (including Schnitzer family companies) require the approval of the Company's Audit Committee, and the Company is in compliance with this policy.

Thomas D. Klauer, Jr., President of the Company's Auto Parts Business, is the sole shareholder of a corporation that is the 25% minority partner in a partnership with the Company that operates four Pick-N-Pull stores in Northern California. Mr. Klauer's 25% share of the profits of this partnership totaled \$0.2 million and \$0.3 million in the second fiscal quarter of 2006 and 2005, respectively, and \$0.6 million and \$0.8 million for the six months ended February 28, 2006 and 2005, respectively. Mr. Klauer also owns the property at one of these stores which is leased to the partnership under a lease providing for annual rent of \$0.2 million, subject to annual adjustments based on the Consumer Price Index, and a term expiring in December 2010. The partnership has the option to renew the lease, upon its expiration, for a five-year period.



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**Note 8 - Stock Incentive Plan:**

The Company has adopted the 1993 Stock Incentive Plan (Plan) for its employees, consultants, and directors. Pursuant to the provisions of the Plan, as amended, the Company is authorized to issue up to 7,200,000 shares of Class A Common Stock. At the 2006 Annual Meeting of Shareholders held on January 30, 2006, the Company's shareholders approved amendments to the Plan to (a) authorize the grant of performance-based long-term incentive awards under the Plan that would be eligible for treatment as performance-based compensation under Section 162(m) of the Internal Revenue Code of 1986 and (b) increase the per-employee limit on grants of options and stock appreciation rights under the Plan from 100,000 shares to 150,000 shares annually. The amendments did not include any increase in the number of shares reserved for issuance under the Plan.

Stock Options

Stock options are granted to employees at exercise prices equal to the fair market value of the Company's stock at the dates of grant. Generally, stock options granted to employees fully vest five years from the date of grant and have a contractual term of ten years.

**Adoption of SFAS No. 123(R).** The Company adopted SFAS No. 123 (revised 2004), "Share-Based Payment," effective September 1, 2005. SFAS No. 123(R) requires the recognition of the fair value of stock-based compensation in net income. The Company recognizes compensation expense arising from share-based payments over the requisite service periods of the individual grants, which generally equal the vesting periods.

Prior to September 1, 2005, the Company accounted for the Plan under the intrinsic value method described in Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. The Company, applying the intrinsic value method, did not record stock-based compensation cost in net income because the exercise price of its stock options equaled the market price of the underlying stock on the date of grant. The Company has elected to utilize the modified prospective transition method for adopting SFAS No. 123(R). Under this method, the provisions of SFAS No. 123(R) apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards unvested at the date of adoption, determined under the original provisions of SFAS No. 123, will be recognized in net income in the periods after the date of adoption.

The Company recognized compensation expense in the amount of \$0.5 million and \$1.0 million for the three months and six months ended February 28, 2006, respectively.

The fair value of each option grant under the Plan was estimated at the date of grant using the Black-Scholes Option Pricing Model, which utilizes assumptions related to volatility, the risk-free interest rate, the dividend yield, and employee exercise behavior. Expected volatilities utilized in the model are based primarily on the historical volatility of the Company's stock price and other factors. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect at the time of grant. The model incorporates exercise and post-vesting forfeiture assumptions based on an analysis of historical data. The expected lives of the grants are derived from historical data and other factors.

As of February 28, 2006, the total remaining unrecognized compensation cost related to non-vested stock options amounted to \$5.3 million. The weighted average remaining requisite service period of the non-vested stock options was 26 months.

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In accordance with the applicable provisions of SFAS No. 123(R) and FASB Staff Position (FSP) FAS No. 123(R)-3 issued on November 10, 2005, the Company elected to use the short-form method to calculate the Windfall tax pool (Windfall) as of September 1, 2005, against which any future deficiency in actual tax benefits from exercises of stock options as compared to tax benefits recorded under SFAS No. 123(R), defined as "Shortfall," will be offset. As of September 1, 2005, the Windfall calculated in accordance with the provisions of FSP FAS No. 123(R)-3 amounted to \$11.1 million. For the second quarter of 2006, the additions to the Windfall were \$0.6 million.

**Periods Prior to Adoption.** SFAS No. 123(R) requires the Company to present pro forma information for periods prior to adoption as if the Company had accounted for all stock-based compensation under the fair value method of that statement. For purposes of pro forma disclosure, the estimated fair value of the options at the date of grant is amortized over the requisite service period, which generally equals the vesting period. The following table illustrates the effect on net income and net income per share as if the Company had applied the fair value recognition provisions to its share-based payments:

	For the Three Months Ended February 28, 2005	For the Six Months Ended February 28, 2005
Reported net income	\$ 35,981	\$ 78,917
Add: Stock-based compensation costs included in reported net income, net of tax	225	450
Deduct: Total stock-based employee compensation expense under fair value based method for all awards, net of tax	(207)	(333)
Pro forma net income	\$ 35,999	\$ 79,034
Reported basic income per share	\$ 1.18	\$ 2.60
Pro forma basic income per share	\$ 1.18	\$ 2.60
Reported diluted income per share	\$ 1.15	\$ 2.53
Pro forma diluted income per share	\$ 1.15	\$ 2.54

Prior to fiscal 2006, the Company recognized a liability and recorded compensation expense due to accelerating the vesting period on stock options for a retiring employee. In fiscal 2006, the employee exercised these options and the Company recorded additional paid-in capital of \$1.1 million.

Long-Term Incentive Plan (LTIP)

Subject to shareholder approval of the proposed amendments to the Plan, on November 29, 2005 the Company's Compensation Committee approved performance-based awards under the Plan and the entry by the Company into Long-Term Incentive Award Agreements evidencing those awards. On January 30, 2006, the Compensation Committee approved additional awards on the same terms to two executive officers, also subject to shareholder approval. Shareholder approval of the Plan amendments on January 30, 2006 satisfied the condition to the effectiveness of the awards.

The Committee established a series of performance targets based on the Company's total shareholder return for the performance period relative to the S&P 500 Industrials (weighted at 50%), the operating income per ton of the Company's Metals Recycling Business for the performance period (weighted at 16 2/3%), the number of EVA positive stores of the Auto Parts Business for the last year of the performance period (weighted at 16 2/3%), and the man hours per ton of the Steel Manufacturing Business for the performance period (weighted at 16 2/3%), corresponding to award payouts ranging from 25% to 300% of the weighted portions of the target



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awards. For participants who work exclusively in one business segment, the awards are weighted 50% on the performance measure for their segment and 50% on total shareholder return. A participant generally must be employed by the Company on the October 31 following the end of the performance period to receive an award payout, although pro-rated awards will be paid if employment terminates earlier on account of death, disability, retirement, termination without cause after the first year of the performance period, or a sale of the Company or the business segment for which a participant works. Awards will be paid in the Company's common stock as soon as practicable after the October 31 following the end of the performance period.

In accordance with the applicable provisions of SFAS No. 123(R), the Company recorded compensation costs associated with the Plan of \$0.5 million for the quarter ended February 28, 2006.

**Note 9 - Employee Benefits:**

The Company has a number of retirement benefit plans that cover both union and non-union employees. The Company makes contributions following the provisions in each plan.

Primary actuarial assumptions are determined as follows:

- The expected long-term rate of return on plan assets is based on the Company's estimate of long-term returns for equities and fixed income securities weighted by the allocation of assets in the plans. The rate is affected by changes in general market conditions, but because it represents a long-term rate, it is not significantly affected by short-term market swings. Changes in the allocation of plan assets would also impact this rate;
- The assumed discount rate is used to discount future benefit obligations back to current dollars. The U.S. discount rate is as of the measurement date of August 31, 2005. This rate is sensitive to changes in interest rates. A decrease in the discount rate would increase the Company's obligation and expense;
- The expected rate of compensation increase is used to develop benefit obligations using projected pay at retirement. This rate represents average long-term salary increases and is influenced by the Company's compensation policies. An increase in this rate would increase the Company's obligation and expense.

Defined Benefit Pension Plan

The Company maintains a defined benefit pension plan for certain non-union employees. The components of net periodic pension benefit cost are (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	February 28,		February 28,	
	2006	2005	2006	2005
Service cost	\$ 395	\$ 259	\$ 695	\$ 527
Interest cost	226	158	396	323
Expected return on plan assets	(280)	(194)	(493)	(395)
Amortization of past service cost	1	1	2	2
Recognized actuarial loss	68	45	121	92
Net periodic pension benefit cost	\$ 410	\$ 269	\$ 721	\$ 549

The Company expects to contribute \$1.5 million to its defined benefit pension plan for the year ending August 31, 2006. During the quarter ended February 28, 2006, the Company made no contributions to the defined benefit pension plan. The Company typically makes annual contributions to the plan after it receives the annual actuarial valuation report. These payments are typically made in the Company's third and fourth fiscal quarters.



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Defined Contribution Plans

The Company has several defined contribution plans covering non-union employees. Company contributions to the defined contribution plans were as follows (in thousands):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
Plan costs	\$ 192	\$ 190	\$ 992	\$ 536

Multiemployer Pension Plans

In accordance with collective bargaining agreements, the Company contributes to multiemployer pension plans. Company contributions were as follows (in thousands):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
Plan contributions	\$ 541	\$ 753	\$ 1,411	\$ 1,336

The Company is not the sponsor or administrator of these multiemployer plans. Contributions were determined in accordance with provisions of negotiated labor contracts. The Company is unable to determine its relative portion of or estimate its future liability under the plans.

The Company learned during fiscal 2004 that one of the multiemployer plans for the Steel Manufacturing Business would not meet Employee Retirement Income Security Act of 1974 minimum funding standards for the plan year ended September 30, 2004. The trustees of that plan have applied to the Internal Revenue Service (IRS) for certain relief from this minimum funding standard. The IRS has tentatively responded, indicating a willingness to consider granting the relief provided the plan's contributing employers, including the Company, agree to increased contributions. The increased contributions are estimated to average 6% per year, compounded annually, until the plan reaches the funding status required by the IRS. These increases would be based on the Company's current contribution level to the plan of approximately \$1.7 million per year. Based on commitments from the majority of employers participating in the plan to make the increased contributions, the plan trustees have proceeded with the relief request and are awaiting formal approval from the IRS.

Absent relief by the IRS, the plan's contributing employers will be required to make additional contributions or pay an excise tax that may equal or exceed the full amount of the funding deficiency. The Company estimated its share of the required additional contribution for the 2004 plan year to be approximately \$1.1 million and accrued for such amount in fiscal 2004. The Company did not accrue additional amounts for fiscal 2005 or through the second quarter of fiscal 2006, based on the Company's belief that it is probable the IRS will grant relief.

**Note 10 - Segment Information:**

The Company operates in three industry segments: metal processing, recycling and trading (Metals Recycling Business), self-service and full-service used auto parts sales (Auto Parts Business), and mini-mill steel manufacturing (Steel Manufacturing Business). Additionally, the Company is a non-controlling partner in joint ventures that are suppliers of unprocessed metals and, prior to October 1, 2005, other joint ventures in the metals recycling business. In

prior fiscal years, the Company considered these joint ventures to be separate segments because they were managed separately. These joint ventures are accounted for using the equity method. As such, the operating information related to the joint ventures is shown separately from consolidated

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information, except for the Company's equity in the net income of, investments in and advances to the joint ventures. Additionally, assets and capital expenditures are not shown for the joint ventures, as management does not use that information to allocate resources or assess performance. The Company does not allocate to its operating segments corporate interest income and expense, income taxes, or other income and expenses related to corporate activity.

Revenues from external customers and from intersegment transactions for the Company's consolidated operations are as follows (in thousands):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
			(as restated)	
Metals Recycling Business	\$ 294,983	\$ 152,080	\$ 536,413	\$ 296,612
Auto Parts Business	49,982	24,448	95,904	47,834
Steel Manufacturing Business	89,535	66,820	178,691	136,842
Intersegment revenues	(31,215)	(27,602)	(66,492)	(66,581)
Consolidated revenues	\$ 403,285	\$ 215,746	\$ 744,516	\$ 414,707

The Company's operating income is as follows (in thousands):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
			(as restated)	
Metals Recycling Business	\$ 18,867	\$ 31,756 <sup>(3)</sup>	\$ 32,601 <sup>(1)</sup>	\$ 65,544 <sup>(3)</sup>
Auto Parts Business	3,630	6,963	11,367	13,952
Steel Manufacturing Business	16,246	5,358	32,316	18,118
Joint Ventures <sup>(2)</sup>	—	16,205	—	36,669
Total segment operating income	38,743	60,282	76,284	134,283
Corporate expense	(8,987)	(5,008)	(28,466)	(8,599)
Intercompany profit eliminations	1,814	739	1,285	(2,424)
Total operating income	\$ 31,570	\$ 56,013	\$ 49,103	\$ 123,260

<sup>(1)</sup>The Company elected to consolidate results of two of the businesses acquired through the HNC separation and termination agreement as though the transaction had occurred at the beginning of fiscal 2006 instead of as of the date of acquisition. The increases in revenues and operating income that resulted from the election offset by pre-acquisition interests, net of tax. See Note 2 and Note 4 to the condensed consolidated financial statements.

<sup>(2)</sup>As a result of the HNC joint venture separation and termination, the Joint Venture segment was eliminated and the results for the businesses acquired in this transaction that the Company is now managing, along with other smaller joint ventures, have been consolidated into the Metals Recycling Business beginning in fiscal 2006. Included in the Joint Venture segment for fiscal 2005 is estimated operating income for the acquired businesses of \$2,844 and \$11,814 for the three and six months ended February 28, 2006, respectively.

<sup>(3)</sup>Includes \$7,725 and \$8,225 of environmental expenses related to the Hylebos Waterway project for the three and six months ended February 28, 2005, respectively. See Note 5 to the condensed consolidated financial statements.



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**Note 11 - Subsequent Events:**

On January 13, 2006, the Company entered into an agreement to sell its approximately one acre parcel in Portland, Maine on which it conducts metals recycling operations to the City of Portland for \$0.6 million and to purchase a thirteen acre site from the City of Portland for approximately \$1.5 million. Upon closing of the sales the City will lease the one acre parcel to the Company until the Company has relocated its metals recycling operations to the newly acquired property. Additionally, the City of Portland has agreed to pay the Company \$1.0 million to reimburse costs to relocate its operations.

On March 3, 2006, the Company fulfilled its stated intention to have its board composed of a majority of independent directors by electing William D. Larsson to its Board of Directors. Mr. Larsson is Senior Vice President and Chief Financial Officer of Precision Castparts Corp. At the Company's 2006 annual meeting of shareholders held in January, two other independent directors were elected: Judith A. Johansen, former Chief Executive Officer of PacificCorp, and Mark L. Palmquist, Executive Vice President and Chief Operating Officer, Grains and Foods, of CHS, Inc. The new directors join incumbent independent directors Robert Ball, William Furman and Ralph Shaw.

On March 21, 2006 the Company adopted a shareholders rights plan (the "Rights Plan"). Under the Rights Plan, the Company issued a dividend of one preferred share purchase right (a "Right") for each share of Class A Common Stock or Class B Common Stock held by shareholders of record as of the close of business on April 4, 2006. Except as provided below, each Right entitles shareholders to buy one one-thousandth of a share of Series A Participating Preferred Stock ("Series A Shares") of the Company at an exercise price of \$110.00, subject to adjustment in certain circumstances (e.g. for stock splits or stock dividends).

The Rights will initially trade with the Company's common stock and are not exercisable. The Rights generally become exercisable if a person or group (other than the Schnitzer Steel Industries, Inc. Voting Trust or its trustees in their capacity as such) acquires beneficial ownership of 15% or more of the Company's common stock or of the voting power of the Company's common stock or if a person or group commences a tender or exchange offer that would have a similar effect. When the Rights become exercisable, holders of a Right (other than the unsolicited third party acquirer), shall be entitled to receive, in lieu of Series A Shares, common stock of the Company or of any third party acquirer having a value of twice the Rights' then-current exercise price. The Company can redeem the Rights for \$0.001 per Right prior to the time any person or group acquires 15% or more of the Company's common stock or of the voting power of the Company's common stock. The Rights will expire on March 21, 2016.

On March 21, 2006, the Company purchased the forty percent minority interest in its Rhode Island metals recycling subsidiary. The purchase price of \$25.3 million was paid in cash.

Also, see Note 6 to the condensed consolidated financial statements regarding an increase in the Company's unsecured credit line in March 2006.

On March 29, 2006, the Company entered into a lease for its facility in Providence, Rhode Island. The lease has an initial term which expires December 31, 2010 and contains five five-year renewal options. The Company also has the right to terminate the lease before the end of the term under certain circumstances. Rent and fees under the lease are fixed for the initial term, are subject to annual minimums, and are subject to adjustment during the renewal terms based on the formulas in the lease. In connection with the execution of the lease, the parties settled and dismissed litigation pending between the parties, resulting in an exchange of releases.





SCHNITZER STEEL INDUSTRIES, INC.

ITEM 2.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**Restatement**

The Company has restated its condensed consolidated statement of operations for the six months ended February 28, 2006 and its consolidated statements of cash flows for the six months ended February 28, 2006 and 2005. See Note 1 to the condensed consolidated financial statements for additional details. All amounts in the following discussion have been restated where necessary for the effect of the restatement.

**General**

Schnitzer Steel Industries, Inc. (the Company) operates in three vertically integrated business segments consisting of metal processing, recycling and trading (Metals Recycling Business), self-service and full-service used auto parts sales (Auto Parts Business), and mini-mill steel manufacturing (Steel Manufacturing Business). The Metals Recycling Business collects, processes and recycles metals by operating one of the largest metals recycling businesses in the United States. The Auto Parts Business operates as Pick-N-Pull, which the Company believes is one of the country's leading self-service used auto parts networks, and as GreenLeaf, which the Company acquired in September 2005 and positions the Company in the full-service used auto parts market. Pick-N-Pull is also a supplier of auto bodies to the Metals Recycling Business, which processes the auto bodies into sellable recycled metal. The Steel Manufacturing Business purchases recycled metals from the Metals Recycling Business and other sources and uses its mini-mill to process the recycled metals into finished steel products. As a result of the vertical integration, the Company is able to transform auto bodies and other unprocessed metals into finished steel products. The acquisition of GreenLeaf is part of a growth strategy that the Company began to implement in fiscal 2005 through a series of business acquisitions in its Metals Recycling and Auto Parts Businesses.

*Metals Recycling Business*

The Company operates one of the largest metal recycling businesses in the United States. The Company buys, processes and sells ferrous metals to foreign and domestic steel producers, including its Steel Manufacturing Business, and nonferrous metals to both the domestic and export markets. In addition, the Metals Recycling Business engages in the metals trading business by purchasing processed metal from other recycled metals processors for shipment to either the Steel Manufacturing Business or third party customers without further processing.

On September 30, 2005, the Company and Hugo Neu Corporation (HNC) closed a transaction to separate and terminate their metals recycling joint venture relationships. As a result of this transaction, in addition to its previous recycling operations in Northern California, Washington and Oregon, the Company acquired recycling operations in the Northeast and Hawaii. In addition, the Company acquired full ownership of a metals trading business which purchases metals in parts of Russia and the Baltic region and the Company operated, through its wholly owned subsidiary, Schnitzer Global Exchange Corp. (Schnitzer Global Exchange). On October 31, 2005, the Company also purchased substantially all of the assets of Regional Recycling LLC (Regional), which operates ten metals recycling facilities located in Georgia and Alabama and gives the Company a significant presence in the growing market in Southeastern United States. Regional processes ferrous and nonferrous scrap metals without the use of shredders. For additional details concerning the HNC joint venture separation and termination and the Regional acquisition, see "Acquisitions and Transactions" below and Note 4 to the condensed consolidated financial statements.

SCHNITZER STEEL INDUSTRIES, INC.

Auto Parts Business

The Auto Parts Business operates as Pick-N-Pull and GreenLeaf in the United States and Canada. The Company believes Pick-N-Pull is one of the country's leading self-service used auto parts networks. The Auto Parts Business purchases used and salvaged vehicles, sells used parts from those vehicles through its retail stores and wholesale operations, and sells the remaining portion of the vehicles to metal recyclers, including the Company's Metals Recycling Business. Until September 30, 2005, the Auto Parts Business consisted of a network of Pick-N-Pull retail locations in ten states and two Canadian provinces operating exclusively as self-service used auto parts stores. These stores are self-service in that customers themselves remove used auto parts from vehicles in inventory.

During the first quarter of fiscal 2006, the Company acquired GreenLeaf, which is engaged in the business of full-service used auto parts sales primarily to commercial customers such as collision and mechanical repair shops. The acquired GreenLeaf locations are in Arizona, Florida, Georgia, Illinois, Massachusetts, Nevada, North Carolina, Ohio, Virginia and Texas. This acquisition significantly increased the presence of the Auto Parts Business in the southern, eastern and midwestern United States and represents the Company's initial venture into the substantial full-service segment of the recycled auto parts market that services commercial customers. In full-service stores, professional staff members dismantle, test and inventory individual parts, which are then delivered to business or wholesale customers. Full-service stores also generally maintain newer cars in inventory. The Company is in the process of integrating GreenLeaf's operations into Pick-N-Pull. Management has identified several GreenLeaf stores to convert to self-service locations; others will combine both full-service and self-service, and some will remain exclusively full-service. As of February 28, 2006, two of the acquired GreenLeaf locations have been closed and one has been converted to a self-service location. In addition, three of the locations serve as sales offices only. As of February 28, 2006, GreenLeaf operated its full service used auto parts sales business in three wholesale sales offices and 15 commercial locations throughout the United States. For additional details concerning the GreenLeaf acquisition, see "Acquisitions and Transactions" below and Note 4 to the condensed consolidated financial statements.

Steel Manufacturing Business

The Steel Manufacturing Business purchases recycled metals from the Metals Recycling Business as well as from third parties and uses its mini-mill to process the recycled metals into finished steel products, including steel reinforcing bar (rebar), wire rod, merchant bar, coiled rebar and other specialty products.

**Acquisitions and Transactions**

**Metals Recycling Business.** On September 30, 2005, the Company, HNC and certain of their subsidiaries closed a transaction to separate and terminate their metals recycling joint venture relationships. The Company received the following as a result of the HNC joint venture separation and termination:

- The assets and related liabilities of Hugo Neu Schnitzer Global Trade related to a trading business in parts of Russia and the Baltic region, including Poland, Denmark, Finland, Norway and Sweden, and a non-compete agreement from HNC that bars it from buying scrap metal in certain areas in Russia and the Baltic region for a five-year period ending on June 8, 2010;
- The joint ventures' various interests in the Northeast operations that primarily operate in Massachusetts, New Hampshire, Rhode Island and Maine;
  - Full ownership in the Hawaii metals recycling business that was previously owned 100% by HNC;
  - A payment of \$36.6 million in cash, net of debt paid, subject to post-closing adjustments.

SCHNITZER STEEL INDUSTRIES, INC.

HNC received the following as result of the HNC joint venture separation and termination:

- The joint venture operations in New York, New Jersey and California, including the scrap processing facilities, marine terminals and related ancillary satellite sites, the interim New York City recycling contract, and other miscellaneous assets;
- The assets and related liabilities of Hugo Neu Schnitzer Global Trade that are not related to the Russian and Baltic region trading business.

As described above, the separation resulted in the exchange of the joint venture interests, as well as cash and other assets, to provide for an equitable division. The agreement provides for potential purchase price adjustments based on the closing date working capital of the acquired Hawaii business as well as the joint ventures' ending balances. The Company is in the process of determining whether any purchase price adjustments are necessary.

On October 31, 2005, the Company purchased substantially all of the assets of Regional for \$65.5 million in cash and the assumption of certain liabilities.

**Auto Parts Business.** On September 30, 2005, the Company acquired GreenLeaf, five properties previously leased by GreenLeaf and certain GreenLeaf debt obligations. The total purchase price for the acquisition was \$44.5 million, subject to post-closing adjustments. This acquisition may have a modestly dilutive effect on operating income in fiscal 2006 as the Company integrates GreenLeaf's operations into Pick-N-Pull and converts certain stores to self-service locations or combination full-service and self-service locations, but is expected to provide growth in future years.

Management believes that the HNC joint venture separation and termination and the Regional and GreenLeaf acquisitions position the Company well as it continues to execute its growth strategy. Consideration for these recently acquired businesses was funded by the Company's cash balances on hand and borrowings under its bank credit facility. The Company has recorded estimated environmental liabilities as a result of due diligence performed in connection with these acquisitions. See Note 5 to the condensed consolidated financial statements for further information regarding environmental and other contingencies.

## SCHNITZER STEEL INDUSTRIES, INC.

**Results of Operations**

The Company's revenues and operating results by business segment are summarized below (in thousands):

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006	2005
	(as restated)			
<b>REVENUES:</b>				
<b>Metals Recycling Business:</b>				
<b>Ferrous sales:</b>				
Processing	\$ 205,579	\$ 133,647	\$ 335,116 <sup>(1)</sup>	\$ 260,479
Trading	33,312	—	112,001	—
Nonferrous sales	54,301	16,943	85,829 <sup>(1)</sup>	32,597
Other sales	1,791	1,490	3,467	3,536
Total sales	294,983	152,080	536,413	296,612
Auto Parts Business	49,982	24,448	95,904 <sup>(1)</sup>	47,834
Steel Manufacturing Business	89,535	66,820	178,691	136,842
Intercompany sales eliminations	(31,215)	(27,602)	(66,492)	(66,581)
Total revenues	\$ 403,285	\$ 215,746	\$ 744,516	\$ 414,707
<b>OPERATING INCOME (LOSS):</b>				
<b>Metals Recycling Business:</b>				
Processing	\$ 19,594	\$ 31,756 <sup>(3)</sup>	\$ 33,116 <sup>(1)</sup>	\$ 65,544 <sup>(3)</sup>
Trading	(727)	--	(515)	—
Auto Parts Business	3,630	6,963	11,367 <sup>(1)</sup>	13,952
Steel Manufacturing Business	16,246	5,358	32,316	18,118
Joint Ventures <sup>(2)</sup>	—	16,205	—	36,669
Total segment operating income	38,743	60,282	76,284	134,283
Corporate expense	(8,987)	(5,008)	(28,466)	(8,599)
Intercompany profit eliminations	1,814	739	1,285	(2,424)
Total operating income	\$ 31,570	\$ 56,013	\$ 49,103	\$ 123,260
NET INCOME	\$ 21,118	\$ 35,981	\$ 62,648	\$ 78,917

<sup>(1)</sup> The Company elected to consolidate results of two of the businesses acquired through the HNC separation and termination agreement as though the transaction had occurred at the beginning of fiscal 2006 instead of as of the date of acquisition. The increases in revenues and operating income that resulted from the election offset by pre-acquisition interests, net of tax. See Note 2 and Note 4 to the condensed consolidated financial statements.

<sup>(2)</sup> As a result of the HNC joint venture separation and termination, the Joint Venture segment was eliminated and the results for the businesses acquired in the transaction, along with other smaller joint ventures have been consolidated into the Metals Recycling Businesses segment beginning in fiscal 2006.

<sup>(3)</sup> Includes \$7,725 and \$8,225 of environmental expenses related to the Hylebos Waterway project for the three and six months ended February 28, 2005, respectively. See Note 5 to the condensed consolidated financial statements.



## SCHNITZER STEEL INDUSTRIES, INC.

The following table summarizes certain selected operating data for the Company:

	For the Three Months Ended February 28,		For the Six Months Ended February 28,	
	2006	2005	2006 (as restated)	2005
<b>METALS RECYCLING BUSINESS:</b>				
Average Ferrous Recycled Metal Sales Prices (\$/LT) <sup>(1)</sup>				
Domestic	\$ 202	\$ 220	\$ 204	\$ 221
Export	195	247	199	246
Total Processing	197	240	201	238
Trading	178	—	203	—
Ferrous Processing Sales Volume (LT, in thousands) <sup>(2)</sup>				
Steel Manufacturing Business	148	110	302	269
Domestic	158	9	217	26
Export	606	357	942	652
Total	912	476	1,461	947
Ferrous Trading Sales Volumes (LT, in thousands)				
	154	—	461	—
Nonferrous Sales Volumes (pounds, in thousands) <sup>(2)</sup>				
	71,800	30,932	121,835	60,300
<b>STEEL MANUFACTURING BUSINESS:</b>				
Average Sales Price (\$/ton) <sup>(1)</sup>				
	\$ 522	\$ 517	\$ 519	\$ 525
Finished Steel Products Sold (tons, in thousands)				
	165	125	331	251
<b>AUTO PARTS BUSINESS:</b>				
Number of Self-Service Locations at				
End of Quarter	31	30		
Number of Full-Service Locations at				
End of Quarter <sup>(3)</sup>	18	—		

<sup>(1)</sup>Price information is shown after a reduction for the cost of freight incurred to deliver the product to the customer.

<sup>(2)</sup>The Company elected to consolidate results of two of the businesses acquired through the HNC separation and termination agreement as though the transaction had occurred at the beginning of fiscal 2006 instead of the date of acquisition. As a result of current acquisitions, ferrous volume increased on a pro forma basis by 1,035,000 tons and nonferrous volume increased by 59,000 pounds. See Note 2 and Note 4 to the condensed consolidated financial statements.

<sup>(3)</sup> Reflects the addition of GreenLeaf to the Auto Parts Business in the first quarter of fiscal 2006.



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**General.** During the first quarter, the Company added significant new operations to its Metals Recycling and Auto Parts Businesses through the separation and termination of its joint ventures with HNC and the acquisitions of Regional and GreenLeaf. As a result of these acquisitions, the Company's revenues have increased 80% compared with the first half of last fiscal year. The Company began the process of integrating the newly acquired businesses into its existing operations during the first quarter of fiscal 2006, and continued its efforts through the second quarter. The Company also continued a major capital spending program to upgrade and replace infrastructure and equipment. The recent acquisitions and capital improvements are expected to provide long-term benefits, although management expects they will result in some short-term disruption to operations.

Results for the Steel Manufacturing Business and the Auto Parts Business continue to be strong. Compared with the second quarter and year-to-date last year, operating results for the Steel Manufacturing Business improved due to stronger demand for rebar products. The Metals Recycling Business was impacted by a number of short-term factors that reduced sales volumes and margins. Operating income declined for the Metals Recycling Business as margins for ferrous metals were compressed by lower selling prices and relatively higher purchase costs for unprocessed metal.

As a result of the HNC joint venture separation and termination, the Joint Venture segment was eliminated and the results for the businesses acquired in this transaction, along with other smaller joint ventures, have been consolidated into the Metals Recycling Business beginning in fiscal 2006. Beginning in fiscal 2006, the average margins for the Metals Recycling Business are impacted by Schnitzer Global Exchange, the Company's new trading business, which has different characteristics and produces lower margins than the processing business. Additionally the Northeast recycling facilities acquired in the HNC transaction operate in a highly competitive market and are expected to have lower margins as compared to the Company's original West Coast operations.

The Company's results of operations depend in large part on demand and prices for recycled metals in world markets and steel products in the Western United States. Beginning in fiscal 2004, and continuing into the first half of fiscal 2005, strong worldwide demand combined with a tight supply of recycled metals created significant price volatility and drove the Metals Recycling Business' average selling prices to unprecedented highs. Average selling prices for recycled ferrous metals declined in the second half of fiscal 2005 due to the unsettled Asian markets, and continued to decline in the first half of fiscal 2006. However, even with these conditions, margins remain strong from a historical perspective caused by a finite supply of scrap metal and firm demand for finished steel products. In particular, the fluctuations of prices for recycled ferrous metals have a significant impact on the results of operations for the Metals Recycling Business and to a lesser extent on the Auto Parts Business.

For both the full-service and self-service Auto Parts Business, revenues for the wholesale product lines are principally affected by commodity metal prices. Year-to-date, the Auto Parts Business has been affected by the decline in the average selling prices for recycled metals, which has resulted in lower prices for crushed auto bodies as compared to the same period last year. Additionally, the strong domestic markets continue to support higher purchase prices for those vehicles. The self-service retail operations are somewhat seasonal and affected by weather conditions and promotional events. Since the stores are open to the natural elements, during periods of prolonged wet, cold or extreme heat, the retail business tends to slow due to the difficult working conditions for customers. As a result, the Company's first and third fiscal quarters tend to generate the greatest retail sales and the second and fourth fiscal quarters are slower for these operations.

Customer demand for steel products on the West Coast is very good, and average prices for the Company's Steel Manufacturing Business remain strong by historical standards. However, there has been an increase in the amount of imported wire rod which has lower selling prices than the Company's comparable products being delivered on the West Coast.





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**Second Quarter Fiscal 2006 Compared to Second Quarter Fiscal 2005**

**Revenues.** Consolidated revenues for the quarter ended February 28, 2006 increased \$187.5 million, or 87% from \$215.7 million in the second quarter of fiscal 2005. Revenues for the second quarter of fiscal 2006 increased for all of the Company's business segments. The Metals Recycling Business' revenues increased primarily as a result of the businesses acquired in the HNC separation and termination, and the acquisition of Regional. In addition, export shipments in the second quarter rose from the lower levels experienced at the end of fiscal 2005 and into the first quarter of fiscal 2006. Demand for scrap metals in the worldwide metals markets continues to be strong. The Auto Parts Business' revenues increased primarily as a result of the acquisition of GreenLeaf in September 2005 and four newly acquired self-service stores in January 2005. The Steel Manufacturing Business' revenues increased primarily as a result of strong West Coast demand, which led to higher selling prices for finished steel products and higher sales volumes.

The Metals Recycling Business generated revenues of \$295.0 million for the quarter ended February 28, 2006, before intercompany eliminations, an increase of \$142.9 million, or 94%, over the same period of the prior year. This increase was caused by higher sales volume provided by the newly acquired businesses, which added revenue of approximately \$146.6 million.

Ferrous revenues for the Company's metals processing operations increased \$71.9 million, or 54%, to \$205.6 million. Total ferrous sales volume for the processing operations increased 436,000 tons, or 91%, over the prior year second quarter to 912,000 tons, which was largely due to the newly acquired businesses in the Southeastern and Northeastern United States. Sales volume for the Company's previously owned West Coast operations increased 77,000 tons. The increase in volume was offset by an 18% decrease in the average net sales price to \$197 per ton for the Company's processed metals operations. Sales to the Steel Manufacturing Business increased 38,000 tons, or 35%, to 148,000 tons, while other domestic sales increased from 9,000 tons in the second fiscal quarter of 2005 to 158,000 tons in the same quarter of this year as a result of the Regional acquisition. Regional is situated in a growing recycled metals market in the Southeastern United States, which is home to many automobile and auto parts manufacturers. Regional sells its ferrous metal to domestic steel mills in its area, of which there are more than 20. The newly acquired metals trading operations of Schnitzer Global Exchange contributed \$33.3 million in revenues, based on sales of 154,000 tons, for the second quarter of fiscal 2006.

Revenue from the Metals Recycling Business' nonferrous metal sales increased \$37.4 million, or 220%, over the prior year second quarter, which resulted from a \$0.20, or 37%, increase in aver