

COMFORT SYSTEMS USA INC
Form 10-Q
May 02, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from _____ to _____

Commission file number: 1-13011

COMFORT SYSTEMS USA, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction
of incorporation or organization)

76-0526487
(I.R.S. Employer
Identification No.)

777 Post Oak Boulevard
Suite 500
Houston, Texas 77056
(Address of Principal Executive Offices) (Zip Code)
Registrant's telephone number, including area code: **(713) 830-9600**

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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 (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares outstanding of the issuer's common stock, as of May 1, 2007 was 40,954,277.

COMFORT SYSTEMS USA, INC.
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FOR THE QUARTER ENDED MARCH 31, 2007

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

	December 31, 2006	March 31, 2007 (Unaudited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 90,286	\$ 69,038
Accounts receivable, less allowance for doubtful accounts of \$3,301 and \$3,977, respectively	234,763	236,854
Other receivables	5,920	5,975
Inventories	8,762	10,309
Prepaid expenses and other	13,644	11,280
Costs and estimated earnings in excess of billings	23,680	22,924
Assets related to discontinued operations	221	7
Total current assets	377,276	356,387
PROPERTY AND EQUIPMENT, net	15,504	17,086
GOODWILL	62,954	65,960
OTHER NONCURRENT ASSETS	6,031	6,815
Total assets	\$ 461,765	\$ 446,248
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$	\$
Accounts payable	81,180	75,971
Accrued compensation and benefits	35,058	24,650
Billings in excess of costs and estimated earnings	65,949	64,807
Income taxes payable	734	
Accrued self insurance expense	19,618	20,232
Other current liabilities	15,476	14,804
Liabilities related to discontinued operations	450	376
Total current liabilities	218,465	200,840
LONG-TERM DEBT, NET OF CURRENT MATURITIES		
OTHER LONG-TERM LIABILITIES	586	1,459
Total liabilities	219,051	202,299
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY:		
Preferred stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding		
Common stock, \$.01 par, 102,969,912 shares authorized, 40,710,003 and 40,943,027 shares issued, respectively	407	409
Treasury stock, at cost, none outstanding		
Additional paid-in capital	339,589	339,056
Deferred compensation		
Retained earnings (deficit)	(97,282)	(95,516)
Total stockholders equity	242,714	243,949
Total liabilities and stockholders equity	\$ 461,765	\$ 446,248

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

COMFORT SYSTEMS USA, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)
(Unaudited)

	Three Months Ended	
	March 31,	
	2006	2007
REVENUES	\$ 236,385	\$ 249,640
COST OF SERVICES	199,617	213,126
Gross profit	36,768	36,514
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	29,743	34,377
GAIN ON SALE OF ASSETS	(20)	(19)
Operating income	7,045	2,156
OTHER INCOME (EXPENSE):		
Interest income	646	715
Interest expense	(155)	(164)
Other	19	33
Other income (expense)	510	584
INCOME BEFORE INCOME TAXES	7,555	2,740
INCOME TAX EXPENSE	3,021	934
INCOME FROM CONTINUING OPERATIONS	4,534	1,806
DISCONTINUED OPERATIONS:		
Operating loss, net of income tax benefit of \$111 and \$	(207)	
NET INCOME	\$ 4,327	\$ 1,806
INCOME PER SHARE:		
Basic		
Income from continuing operations	\$ 0.11	\$ 0.04
Discontinued operations		
Loss from operations		
Net income	\$ 0.11	\$ 0.04
Diluted		
Income from continuing operations	\$ 0.11	\$ 0.04
Discontinued operations		
Loss from operations		
Net income	\$ 0.11	\$ 0.04
SHARES USED IN COMPUTING INCOME PER SHARE:		
Basic	39,857	40,499
Diluted	40,862	41,303
DIVIDENDS PER SHARE	\$ 0.035	\$ 0.035

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

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

	Common Stock		Treasury Stock		Additional	Deferred	Retained	Total
	Shares	Amount	Shares	Amount	Paid-In	Compensation	Earnings	Stockholders
					Capital		(Deficit)	Equity
BALANCE AT								
DECEMBER 31, 2005	39,979,867	\$ 400		\$	\$ 340,264	\$ (1,135)	\$ (126,006)	\$ 213,523
Issuance of Stock:								
Issuance of shares for								
options exercised including								
tax								
benefit	592,636	6	61,360	786	3,868			4,660
Issuance of								
restricted stock	137,500	1			(1)			
Shares received in lieu								
of tax withholding payment								
on vested restricted stock			(46,985)	(597)				(597)
Statement 123R adoption					(1,135)	1,135		
Stock-based compensation								
expense					1,800			1,800
Forfeiture of unvested								
restricted stock			(14,375)	(189)	151			(38)
Tax benefit from vesting of								
restricted stock					316			316
Dividends					(5,674)			(5,674)
Net income							28,724	28,724
BALANCE AT								
DECEMBER 31, 2006	40,710,003	407			339,589		(97,282)	242,714
Issuance of Stock:								
Issuance of shares								
for options exercised								
including tax benefit								
(unaudited)	59,405		4,720	57	378			435
Issuance of restricted stock								
(unaudited)	173,619	2			(2)			
Shares received in lieu								
of tax withholding payment								
on vested restricted stock								
(unaudited)			(4,720)	(57)				(57)
Stock-based compensation								
expense (unaudited)					488			488
FIN 48 adoption								
(unaudited)							(40)	(40)
Tax benefit from vesting of								
restricted stock (unaudited)					29			29
Dividends (unaudited)					(1,426)			(1,426)
Net income							1,806	1,806
(unaudited)								
BALANCE AT								
MARCH 31, 2007	40,943,027	\$ 409		\$	\$ 339,056	\$	\$ (95,516)	\$ 243,949
(unaudited)								

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

COMFORT SYSTEMS USA, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Three Months Ended	
	March 31,	
	2006	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,327	\$ 1,806
Adjustments to reconcile net income to net cash used in operating activities		
Depreciation and amortization expense	1,258	1,544
Bad debt expense	74	821
Deferred tax expense	788	916
Amortization of debt financing costs	25	26
Gain on sale of assets	(16)	(19)
Stock-based compensation expense	326	488
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures		
(Increase) decrease in		
Receivables, net	(9,363)	1,561
Inventories	(169)	(1,462)
Prepaid expenses and other current assets	(790)	(699)
Costs and estimated earnings in excess of billings	(2,257)	950
Other noncurrent assets	117	202
Increase (decrease) in		
Accounts payable and accrued liabilities	(11,518)	(16,484)
Billings in excess of costs and estimated earnings	3,710	(2,478)
Taxes paid related to the sale of businesses	(7,020)	
Net cash used in operating activities	(20,508)	(12,828)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,049)	(2,490)
Proceeds from sales of property and equipment	109	41
Proceeds from businesses sold, net of cash sold and transaction costs	24,595	32
Cash paid for acquisition and intangible assets, net of cash acquired		(4,455)
Net cash provided by (used in) investing activities	22,655	(6,872)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings on revolving line of credit		
Payments on debt acquired		(252)
Debt financing costs		(312)
Payments of dividends to shareholders	(1,404)	(1,426)
Tax benefit of stock-based compensation	969	237
Proceeds from exercise of options	1,056	205
Net cash provided by (used in) financing activities	621	(1,548)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,768	(21,248)
CASH AND CASH EQUIVALENTS, beginning of year continuing operations and discontinued operations	55,593	90,286
CASH AND CASH EQUIVALENTS, end of year continuing operations and discontinued operations	\$ 58,361	\$ 69,038

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

COMFORT SYSTEMS USA, INC.
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)

1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation (Comfort Systems and collectively with its subsidiaries, the Company), is a national provider of comprehensive heating, ventilation and air conditioning (HVAC) installation, maintenance, repair and replacement services within the mechanical services industry. The Company operates primarily in the commercial, industrial and institutional HVAC markets, and performs most of its services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, the Company provides specialized applications such as building automation control systems, fire protection, process cooling, electronic monitoring and process piping. Certain locations also perform related activities such as electrical service and plumbing. Approximately 58% of the Company s consolidated 2007 revenues to date are attributable to installation of systems in newly constructed facilities, with the remaining 42% attributable to maintenance, repair and replacement services. The following service activities account for the Company s consolidated 2007 revenues to date: HVAC 76%, plumbing 17%, building automation control systems 3%, and other 4%. These service activities are within the mechanical services industry which is the single industry segment served by Comfort Systems.

2. Summary of Significant Accounting Policies

Basis of Presentation

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission (SEC) for the year ended December 31, 2006 (the Form 10-K).

There were no significant changes in the accounting policies of the Company during the current period except for the adoption of Financial Accounting Standards Board (FASB) Interpretation No.48, Accounting for Uncertainty in Income Taxes (FIN 48), as further discussed in Note 7. For a description of the significant accounting policies of the Company, refer to Note 2 of Notes to Consolidated Financial Statements of Comfort Systems included in the Form 10-K.

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

Cash Flow Information

Cash paid for interest for the three months ended March 31, 2006 and 2007 was approximately \$0.1 million and \$0.2 million, respectively. Cash paid for income taxes for continuing operations for the three months ended March 31, 2006 and 2007 was approximately \$0.7 million and \$1.1 million, respectively. Cash paid for income taxes for discontinued operations for the three months ended March 31,

2006 and 2007 was \$7.0 million and \$, respectively. The taxes paid for discontinued operations for 2006 related to the sale in 2005 of two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. These taxes are included in the caption Taxes paid related to the sale of businesses in the accompanying consolidated statement of cash flows.

Segment Disclosure

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

Use of Estimates

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

Income Taxes

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

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

The effective tax rate associated with results from continuing operations for the first three months of 2007 was 34.1%, compared to 40.0% in 2006. The Company s effective tax rate is generally higher than statutory rates because of the effect of certain expenses that are not deductible for tax purposes. However, the effective tax rate for the first quarter of 2007 is lower than statutory rates primarily due to an increase in the production activity deduction and a change in expected tax expense in a certain jurisdiction. Adjustments to tax reserves are analyzed quarterly as events occur to warrant such changes and are a component of the effective tax rate.

New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income

Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes. The Company adopted FIN 48 effective January 1, 2007. See Note 7.

Reclassifications

Certain reclassifications have been made in prior period financial statements to conform to current period presentation. These reclassifications have not resulted in any changes to previously reported net income for any periods.

3. Acquisition

On March 9, 2007, the Company completed the acquisition of Madera Mechanical Company (Madera), an HVAC contractor based in Tucson, Arizona. The total consideration paid in this transaction was approximately \$4.5 million, comprised entirely of cash less a holdback of \$0.2 million, net of cash acquired. The consolidated balance sheet of Comfort Systems includes a preliminary allocation of the purchase price to the assets acquired and liabilities assumed based on estimates of fair value. The results of operations of Madera are included in the Company's consolidated financial statements from March 10, 2007 through March 31, 2007.

4. Discontinued Operations

Sale of Assets to Mesa Energy Systems, Inc. On June 1, 2006, the Company along with its wholly-owned subsidiary, ARC Comfort Systems USA, Inc. (ARC), entered into an asset purchase agreement to sell certain assets of ARC to Mesa Energy Systems, Inc. (a subsidiary of Emcor Group, Inc.) for approximately \$0.7 million in cash. These assets were sold at book value. The Company shut down the remaining operations of ARC during the third quarter of 2006. The after-tax loss of this company of \$0.2 million for the first three months of 2006 has been reported in discontinued operations under Operating loss, net of income tax benefit.

Sale of Companies to ALC On December 31, 2005, the Company sold two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. (together, ALC) for approximately \$22.9 million in cash, net of transaction costs and a purchase price adjustment based upon the closing balance sheet for the transferred assets. The receivable related to this sale was paid during the first quarter of 2006. The Company paid \$7.0 million in taxes related to this transaction during the first quarter of 2006.

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

	December 31, 2006	March 31, 2007
Accounts receivable, net	\$ 216	\$ 2
Other current assets, net	5	5
Total assets	\$ 221	\$ 7
Accounts payable	\$ 27	\$
Other current liabilities	423	376
Total liabilities	\$ 450	\$ 376

Revenues and pre-tax loss related to the operations discontinued in 2006 are as follows (in thousands):

	Three Months Ended March 31,	
	2006	2007
Revenues	\$ 1,469	\$
Pre-tax loss	\$ (318)	\$

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

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

There are ongoing open matters relating to this transaction that the Company continues to address with Emcor. The Company does not believe these open matters, either individually or in the aggregate, will have a material effect on the Company's financial position when ultimately resolved. The Company maintains reserves for these matters, net of amounts receivable from escrow that it believes will ultimately be applied in settling these matters.

5. Restructuring Charges

The Company recorded restructuring charges of approximately \$3.2 million pre-tax in 2003. These charges included approximately \$1.5 million for severance costs and retention bonuses primarily associated with the curtailment of the Company's energy efficiency marketing activities, a reorganization of the Company's national accounts operations and a reduction in corporate personnel. The restructuring charges for this period also included approximately \$1.6 million for remaining lease obligations and \$0.1 million of other costs recorded in connection with the actions described above. The Company increased its accrual for these remaining lease obligations by \$0.6 million in 2004, \$0.3 million in 2005, \$0.1 million in 2006 and approximately \$22,000 in 2007 based on revised estimates of when and to what extent it believes it can sublease the related facilities. These increases to the accrual were included in Cost of Services and in Selling, General and Administrative Expenses in the Company's consolidated statement of operations. Accrued lease termination costs remaining from past restructuring charges are expected to be completed by 2009.

The following table shows the remaining liabilities associated with the cash portion of the restructuring charges as of December 31, 2006 and March 31, 2007 (in thousands):

Lease termination costs and other:	Balance at Beginning of Period	Additions	Payments	Balance at End of Period
Year ended December 31, 2006	\$ 961	\$ 88 (a)	\$ (363)	\$ 686
Three months ended March 31, 2007	\$ 686	\$ 22 (a)	\$ (134)	\$ 574

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

6. Long-Term Debt Obligations

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

	December 31, 2006	March 31, 2007
Revolving credit facility	\$	\$
Other		
Total debt		
Less current maturities		
Total long-term portion of debt	\$	\$

On February 20, 2007, the Company amended its senior credit facility (the Facility). The Facility consists of a \$100.0 million revolving credit facility which is available for borrowings and letters of credit. The Facility expires in February 2012 and is secured by substantially all of the assets of the Company except for assets related to projects subject to surety bonds. As of March 31, 2007, the total of the Facility was \$100.0 million, with no outstanding borrowings, \$25.7 million in letters of credit outstanding, and \$74.3 million of credit available.

The Company has a choice of two interest rate options for borrowings under the Facility; these rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. The Company estimates that the interest rate applicable to the borrowings under the Facility would be approximately 6.57% as of March 31, 2007. Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20%-0.30% per annum, based on the ratio of debt to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply. The Company is in compliance with all the financial covenants as of March 31, 2007.

7. Income Taxes

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized an increase of approximately \$40,000 in the liability for unrecognized tax benefits, which was accounted for as a decrease to the January 1, 2007 balance of retained earnings. As of the date of adoption and after the impact of recognizing the increase in the liability noted above, the Company's unrecognized tax benefits totaled \$0.9 million.

The company recognizes potential accrued interest and penalties related to unrecognized tax benefits in income tax expense. In conjunction with the adoption of FIN 48, the Company recognized approximately \$0.1 million for the payment of interest and penalties at January 1, 2007, which is included

as a component of the \$0.9 million unrecognized tax benefit noted above. The Company's tax records are subject to review by the Internal Revenue Service for the 2003 tax year forward and by various state authorities for the 2000 tax year forward.

8. Commitments and Contingencies

Claims and Lawsuits

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

The dispute the Company previously disclosed as an alleged delay related to a multi-family construction project has been settled, avoiding the trial which had been scheduled for the second quarter of 2007. The Company's contribution to the settlement, which also includes a contribution from a co-defendant and insurance proceeds, was consistent with the previously established accrual.

Surety

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

Surety market conditions remain challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 30% of the Company's business has required bonds. While the Company has enjoyed a longstanding relationship with its primary surety and has added another surety to further support its bonding needs, current market conditions as well as changes in the sureties' assessment of the Company's operating and financial risk could cause the sureties to decline to issue bonds for the Company's work. If that were to occur, the alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. The Company would likely also encounter concerns from customers, suppliers and other market participants as to its creditworthiness. While the Company believes its general operating and financial characteristics, including a significant amount of cash on its balance sheet, would enable it to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause the Company's revenues and profits to decline in the near term.

Self-Insurance

The Company is substantially self-insured for worker's compensation, employer's liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident

deductibles the Company absorbs under its insurance arrangements for these risks. Losses up to deductible amounts are estimated and accrued based upon known facts, historical trends and industry averages. Loss estimates associated with the larger and longer-developing risks, such as worker's compensation, auto liability and general liability, are reviewed by a third-party actuary quarterly.

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

Worker's Compensation The per-incident deductible for worker's compensation is \$250,000. The next layer, \$250,000 in excess of \$250,000, is covered by the corridor deductible policy explained below. Losses above \$500,000 are determined by statutory rules on a state-by-state basis, and are fully covered by excess worker's compensation insurance.

General and Employer's Liability For general liability and employer's liability, the per incident deductible is \$250,000. The next layer, \$250,000, in excess of \$250,000 is covered by the corridor deductible policy explained below. The Company is fully insured for the next \$500,000 of each loss, then has a single, aggregate excess loss insurance policy that covers losses up to \$50 million across both these risk areas (as well as auto liability noted below).

Auto Liability For auto liability, the per incident deductible is \$250,000. The next layer, \$250,000 in excess of \$250,000, is covered by the corridor deductible policy explained below. The Company is fully insured for the next \$1.5 million of each loss, then has a single, aggregate excess loss insurance policy that covers losses up to \$50 million.

Corridor Deductible Policy Worker's compensation, general liability, and auto liability claims that exceed \$250,000 but are less than \$500,000, are subject to the corridor deductible policy. This policy insures 100% of losses that fall in this layer, once aggregate retained losses within this layer reach \$500,000.

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

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

9. Stockholders' Equity

Earnings Per Share

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

Under EPS calculation methods established by generally accepted accounting principles, including the effect of options whose exercise price exceeds the average market price of the Common Stock for a given period would increase calculated EPS. This impact is called "anti-dilutive." Generally accepted accounting principles for determining EPS require that any options or other common stock equivalents whose inclusion in determining EPS would have an anti-dilutive effect be excluded. Accordingly, options to purchase less than 0.1 million shares of Common Stock at prices ranging from \$13.00 to \$21.125 per share which were outstanding for the three months ended March 31, 2006 and options to purchase 0.1 million shares at prices ranging from \$12.75 to \$21.125 per share which were outstanding for the three months ended March 31, 2007, were not included in the computation of diluted EPS because they were anti-dilutive.

The following table reconciles the number of shares outstanding with the number of shares used in computing basic and diluted earnings per share for each of the periods presented (in thousands):

	Three Months Ended	
	March 31,	
	2006	2007
Common shares outstanding, end of period(a)	40,046	40,535
Effect of using weighted average common shares outstanding	(189)	(36)
Shares used in computing earnings per share basic	39,857	40,499
Effect of shares issuable under stock option plans based on the treasury stock method	889	754
Effect of contingently issuable restricted stock	116	50
Shares used in computing earnings per share diluted	40,862	41,303

(a) Excludes 187,917 and 408,203 shares of unvested contingently issuable restricted stock outstanding as of March 31, 2006 and 2007, respectively.

Share Repurchase Program

On March 29, 2007, the Board of Directors approved a stock repurchase program to acquire up to 1 million shares of its outstanding common stock. The share repurchases will be made from time to time at the Company's discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Company's Board of Directors may modify, suspend, extend or terminate the program at any time.

Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion should be read in conjunction with our historical Consolidated Financial Statements and related notes thereto included elsewhere in this Form 10-Q and the Annual Report on Form 10-K as filed with the Securities and Exchange Commission for the year ended December 31, 2006 (the "Form 10-K"). This discussion contains forward-looking statements regarding our business and industry within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on our current plans and expectations and involve risks and uncertainties that could cause our actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in Item 1A. Company Risk Factors included in our Form 10-K. The terms "Comfort Systems," "we," "us," or "the Company," refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

Introduction and Overview

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

Nature and Economics of Our Business

Approximately 87% of our revenues are earned on a project basis for installation of HVAC systems in newly constructed facilities or for replacement of HVAC systems in existing facilities. Customers hire us to ensure such systems deliver specified or generally expected heating, cooling, conditioning and circulation of air in a facility. This entails installing core system equipment such as packaged heating and air conditioning units, or in the case of larger facilities, separate core components such as chillers, boilers, air handlers, and cooling towers. We also typically install connecting and distribution elements such as piping and ducting. Our responsibilities usually require conforming the systems to pre-established engineering drawings and equipment and performance specifications, which we frequently participate in establishing. Our project management responsibilities include staging equipment and materials to project sites, deploying labor to perform the work, and coordinating with other service providers on the project, including any subcontractors we might use to deliver our portion of the work.

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

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

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

As of March 31, 2007, we had 3,690 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$445,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

We also perform larger HVAC projects. As of March 31, 2007, we had four projects in process with a contract price of between \$15 and \$30 million, 11 projects between \$10 million and \$15 million, 43 projects between \$5 million and \$10 million, and 196 projects between \$1 million and \$5 million. Taken together, projects with contract prices of \$1 million or more totaled \$968.4 million of aggregate contract value as of March 31, 2007, or approximately 59.0%, out of a total contract value for all projects in progress of \$1,642.5 million. Generally, projects closer in size to \$1 million will be completed in one year or less. It is unusual for us to work on a project that exceeds two years in length.

In addition to project work, approximately 13% of our revenues represent maintenance and repair service on already-installed HVAC and controls systems. This kind of work usually takes from a few hours to a few days to perform. Prices to the customer are usually based on the equipment and materials used in the service as well as technician labor time. We usually bill the customer for service work when it is complete, typically with payment terms of up to thirty days. We also provide maintenance and repair service under ongoing contracts. Under these contracts, we are paid regular monthly or quarterly amounts and provide specified service based on customer requirements. These agreements typically cover periods ranging from one to three years and are cancelable on 30 to 60 days notice.

A relatively small but growing portion of our revenues comes from national and regional account customers. These customers typically have multiple sites, and contract with us to perform maintenance and repair service. These contracts may also provide for us to perform new or replacement systems installation. We operate a national call center to dispatch technicians to sites requiring service. We perform the majority of this work with our own employees, with the balance being subcontracted to third parties that meet our performance qualifications. We will also typically use proprietary information systems to

maintain information on the customer's sites and equipment, including performance and service records, and related cost data. These systems track the status of ongoing service and installation work, and may also monitor system performance data. Under these contractual relationships, we usually provide consolidated billing and credit payment terms to the customer.

Profile and Management of Our Operations

We manage our 39 operating units based on a variety of factors. Financial measures we emphasize include profitability, and use of capital as indicated by cash flow and by other measures of working capital principally involving project cost, billings and receivables. We also monitor selling, general, administrative and indirect project support expense, backlog, workforce size and mix, growth in revenues and profits, variation of actual project cost from original estimate, and overall financial performance in comparison to budget and updated forecasts. Operational factors we emphasize include project selection, estimating, pricing, management and execution practices, labor utilization, safety, training, and the make-up of both existing backlog as well as new business being pursued, in terms of project size, technical application and facility type, end-use customers and industries, and location of the work.

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

Economic and Industry Factors

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

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

Operating Environment and Management Emphasis

Nonresidential building construction and renovation activity, as reported by the federal government, declined over the three year period of 2001 to 2003 and has expanded moderately during 2004 and 2005, and was strong during 2006. During the decline and through 2003, we responded to market challenges by

pursuing work in sectors less affected by this downturn, such as government, educational, and health care facilities, and by establishing marketing initiatives that take advantage of our size and range of expertise. We also responded to declining gross profits over those years by reducing our selling, general, and administrative expenses, and our indirect project and service overhead costs. We believe our efforts in these areas partially offset the decline in our profitability over that period. We have experienced notable improvements in both industry activity as well as our own results since 2004, as discussed further under *Results of Operations* below.

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

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

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

Critical Accounting Policies

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

(i) installation, which we account for under the percentage of completion method, and (ii) maintenance, repair and replacement, which we account for as the services are performed, or in the case of replacement, under the percentage of completion method. In addition, we identified other critical accounting policies related to our allowance for doubtful accounts receivable, the recording of our self-insurance liabilities, valuation of deferred tax assets and the assessment of goodwill impairment. These accounting policies, as well as others, are described in Note 2 to the Consolidated Financial Statements included in our Form 10-K.

Percentage of Completion Method of Accounting

Approximately 87% of our revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method as provided by American Institute of Certified Public Accountants Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, contract revenue recognizable at any time during the life of a contract is determined by multiplying expected total contract revenue by the percentage of contract costs incurred at any time to total estimated contract costs. More specifically, as part of the negotiation and bidding process in which we engage in connection with obtaining installation contracts, we estimate our contract costs, which include all direct materials (exclusive of rebates), labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. These contract costs are included in our results of operations under the caption Cost of Services. Then, as we perform under those contracts, we measure such costs incurred, compare them to total estimated costs to complete the contract, and recognize a corresponding proportion of contract revenue. Labor costs are considered to be incurred as the work is performed. Subcontract labor is recognized as the work is performed, but is generally subjected to approval as to milestones or other evidence of completion. Non-labor project cost consists of purchased equipment, prefabricated materials and other materials. Purchased equipment on our projects is substantially produced to job specifications and is a value added element to our work. The costs are considered to be incurred when title is transferred to us, which typically is upon delivery to the worksite. Prefabricated materials, such as ductwork and piping, are generally performed at our shops and recognized as contract costs when fabricated for the unique specifications of the job. Other materials cost are not significant and are generally recorded when delivered to the worksite. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments.

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

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

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

Accounting for Allowance for Doubtful Accounts

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

Accounting for Self-Insurance Liabilities

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

Accounting for Deferred Tax Assets

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

Accounting for Goodwill and Other Intangible Assets

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

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

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

Results of Operations (in thousands):

	Three Months Ended			
	March 31, 2006		2007	
Revenues	\$ 236,385	100.0 %	\$ 249,640	100.0 %
Cost of services	199,617	84.4 %	213,126	85.4 %
Gross profit	36,768	15.6 %	36,514	14.6 %
Selling, general and administrative expenses	29,743	12.6 %	34,377	13.8 %
Gain on sale of assets	(20)		(19)	
Operating income	7,045	3.0 %	2,156	0.9 %
Interest income, net	491	0.2 %	551	0.2 %
Other income	19		33	
Income before income taxes	7,555	3.2 %	2,740	1.1 %
Income tax expense	3,021		934	
Income from continuing operations	4,534	1.9 %	1,806	0.7 %
Discontinued operations - Operating loss, net of tax	(207)			
Net income	\$ 4,327		\$ 1,806	

Revenues Revenues increased \$13.3 million, or 5.6% to \$249.6 million for the first quarter of 2007 compared to the same period in 2006. Approximately 4.9% of the increase in revenues related to internal growth and the remaining 0.7% resulted from the acquisition of Madera Mechanical on March 9, 2007. The internal revenue growth stemmed primarily from generally improving nonresidential facilities markets throughout the United States especially in the institutional markets such as schools and hospitals (approximately \$12.3 million). We have seen increased activity, primarily in our Texas, Arizona, and Maryland operations, resulting from the start-up of several large projects partially offset by decreased activity at our large multi-family operation.

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

Backlog associated with continuing operations as of March 31, 2007 was \$700.5 million (including \$12.5 million from the acquisition of Madera) a 7.1% increase from December 31, 2006 backlog of \$653.8 million, and a 3.6% decrease from March 31, 2006 backlog of \$726.7 million. In addition to the Madera acquisition, the sequential increase in backlog is primarily in the upper Midwest and at our large

multi-family operation. The year over year decrease is primarily from our large multi-family operation working through its larger than usual existing backlog. We plan to continue our involvement in multi-family work; however, we have decided to focus a portion of our resources away from this work and we expect that as a result, the portion of our work that is multi-family will be somewhat lower in 2007 as compared to 2006.

Following the three-year period of industry activity declines from 2001-2003 noted previously, we saw modest year-over-year revenue increases at our ongoing operations beginning in mid-2003 and continuing throughout 2006. We continue to see signs that activity levels in our industry will remain strong throughout 2007. These observations are based on nonresidential construction spending trends, shipment data from HVAC equipment manufacturers, forecasts from construction industry analysts, and anecdotal indications of project consideration.

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

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

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

Gross Profit Gross profit decreased \$0.3 million, or 0.7%, to \$36.5 million for the first quarter of 2007 as compared to the same period in 2006. As a percentage of revenues, gross profit for 2007 was 14.6%, down from 15.6% in 2006. The decrease in gross profit percentage resulted primarily from job underperformance at our large multi-family operation based in Texas (approximately \$6.8 million). This decrease was partially offset by improved profitability at our Alabama operation (\$1.3 million) and at our Southern California operation (approximately \$0.9 million).

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

Selling, General and Administrative Expenses (SG&A) SG&A increased \$4.6 million, or 15.6% for the first quarter of 2007 as compared to the same period in 2006. As a percentage of revenues, SG&A increased from 12.6% in 2006 to 13.8% in 2007. This is primarily due to an increase in the number of selling and overhead personnel to manage internal growth, higher compensation accruals due to strong performance at a number of our operations and an increase in bad debt expense (\$0.7 million).

Interest Income, Net Interest income, net was \$0.5 million and \$0.6 million for the first quarter of 2006 and 2007, respectively.

Income Tax Expense Our effective tax rate associated with results from continuing operations for 2007 was 34.1%, as compared to 40.0% in 2006. Our effective tax rate is generally higher than statutory

rates because of the effect of certain expenses that are not deductible for tax purposes. In addition, adjustments to tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. The decrease in the effective tax rate is primarily due to an increase in the production activity deduction and a change in expected tax expense in a certain jurisdiction.

During 2004, the American Jobs Creation Act of 2004 was signed into law. The primary effect of this legislation was to permit us to claim a deduction for certain of our construction-related activities. This deduction increased from 3% in 2006 to 6% in 2007. This deduction modestly decreased our effective tax rate. We currently estimate that our effective tax rate for full-year 2007 will be between 37% and 40%.

Discontinued Operations

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

Sale of Companies to ALC On December 31, 2005, we sold two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. (together, ALC) for approximately \$22.9 million in cash, net of transaction costs and a purchase price adjustment based upon the closing balance sheet for the transferred assets. The receivable related to this sale was paid during the first quarter of 2006. We paid \$7.0 million in taxes related to this transaction during the first quarter of 2006.

Outlook As noted earlier in this review, while we see signs that industry activity levels are continuing to increase in 2007, our primary emphasis for this year is on margin improvement rather than revenue growth. Our ongoing margin efforts include a focus on improving the results of units that incurred losses or subpar income (including our large multi-family operation based in Texas which had an operating loss of approximately \$7 million during the first quarter of 2007), and on intensified project and service performance training at the unit level. Based on these margin improvement efforts and developments, on our increased level of backlog as compared to recent periods, and on our belief that industry and economic conditions will remain strong, we continue to believe that our full-year 2007 profitability exceed our 2006 results.

Liquidity and Capital Resources:

	Three Months Ended March 31,	
	2006	2007
	(in thousands)	
Cash provided by (used in):		
Operating activities	\$ (20,508)	\$ (12,828)
Investing activities	\$ 22,655	\$ (6,872)
Financing activities	\$ 621	\$ (1,548)
Free cash flow:		
Cash used in operating activities	\$ (20,508)	\$ (12,828)
Taxes paid related to the sale of businesses	7,020	
Purchases of property and equipment	(2,049)	(2,490)
Proceeds from sales of property and equipment	109	41
Free cash flow	\$ (15,428)	\$ (15,277)

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

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

For the three months ended March 31, 2007, we had negative free cash flow of \$15.3 million as compared to negative free cash flow of \$15.4 million in 2006. These negative amounts are a result of an investment in working capital due to higher activity levels and the funding of year end compensation accruals. During the first quarter of 2006, we collected approximately \$24.6 million, primarily related to the sale of two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc.

Credit Facility On February 20, 2007, we amended our senior credit facility. The Facility consists of a \$100.0 million revolving credit facility which is available for borrowings and letters of credit. The Facility expires in February 2012 and is secured by substantially all of our assets except for assets related to projects subject to surety bonds. As of March 31, 2007, the total of the Facility was \$100.0 million, with no outstanding borrowings, \$25.7 million in letters of credit outstanding, and \$74.3 million of credit available.

We have a choice of two interest rate options for borrowings under the Facility; these rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. We estimate that the interest rate applicable to the borrowings under the Facility would be approximately 6.57% as of March 31, 2007. Commitment fees are payable on the portion of the capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20%-0.30% per annum, based on the ratio of debt to Credit Facility Adjusted EBITDA. The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. We are in compliance with all the financial covenants as of March 31, 2007.

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

We enter into noncancelable operating leases for many of our facility, vehicle and equipment needs. These leases allow us to conserve cash by paying a monthly lease rental fee for use of facilities, vehicles and equipment rather than purchasing them. At the end of the lease, we have no further obligation to the

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

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

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

Surety market conditions are currently challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 30% of our business has required bonds. While we have enjoyed a longstanding relationship with our primary surety and we have added another surety to further support our bonding needs, current market conditions as well as changes in our sureties' assessment of our operating and financial risk could cause our sureties to decline to issue bonds for our work. If that were to occur, our alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics, including a significant amount of cash on our balance sheet, would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenues and profits to decline in the near term.

The following recaps the future maturities of our contractual obligations as of March 31, 2007 (in thousands):

	Twelve Months Ended March 31,					Thereafter	Total
	2008	2009	2010	2011	2012		
Operating lease obligations	\$ 9,963	\$ 7,990	\$ 5,445	\$ 3,247	\$ 2,400	\$ 6,449	\$ 35,494

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

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

As of March 31, 2007 we also have \$25.7 million letter of credit commitments, of which \$25.3 million expire in 2007 and \$0.4 million expire in 2008. The substantial majority of these letters of credit are posted with insurers who disburse funds on our behalf in connection with our workers compensation, auto liability and general liability insurance program. These letters of credit provide additional security to the insurers that sufficient financial resources will be available to fund claims on our behalf, many of which develop over long periods of time, should we ever encounter financial duress. Posting of letters of credit for this purpose is a common practice for entities that manage their self-insurance programs through third-party insurers as we do. While most of these letter of credit commitments expire in 2007, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually.

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

Outlook We have generated positive net free cash flow for the last eight calendar years, most of which occurred during challenging economic and industry conditions. We also expect to have no debt, significant borrowing capacity under our credit facility, and substantial uncommitted cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

Seasonality and Cyclical

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

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

New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes. We adopted FIN 48 on January 1, 2007. The adoption of FIN 48 did not have a material impact on our results of operations.

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

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

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

ITEM 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) during the fiscal quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

COMFORT SYSTEMS USA, INC.

PART II OTHER INFORMATION

Item 1. *Legal Proceedings*

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

The dispute we previously disclosed as an alleged delay related to a multi-family construction project has been settled, avoiding the trial which had been scheduled for the second quarter of 2007. Our contribution to the settlement, which also includes a contribution from a co-defendant and insurance proceeds, was consistent with the previously established accrual.

Item 2. *Recent Sales of Unregistered Securities*

None.

Item 6. *Exhibits*

(a) Exhibits.

- 31.1 Rule 13a-14(a) Certification of William F. Murdy pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Rule 13a-14(a) Certification of William George pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Section 1350 Certification of William F. Murdy pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Section 1350 Certification of William George pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

May 2, 2007	COMFORT SYSTEMS USA, INC. By:	<i>/s/ WILLIAM F. MURDY</i> William F. Murdy <i>Chairman of the Board and Chief Executive Officer</i>
May 2, 2007	By:	<i>/s/ WILLIAM GEORGE</i> William George <i>Executive Vice President and Chief Financial Officer</i>
May 2, 2007	By:	<i>/s/ JULIE S. SHAEFF</i> Julie S. Shaeff <i>Senior Vice President and Chief Accounting Officer</i>