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

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended August 31, 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 001-15461

MATRIX SERVICE COMPANY

(Exact name of registrant as specified in its charter)

DELAWARE
(State of incorporation)

73-1352174
(I.R.S. Employer Identification No.)

10701 E. Ute St., Tulsa, Oklahoma 74116-1517
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (918) 838-8822

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

As of October 1, 2006, there were 24,686,782 shares of the Company's common stock, \$0.01 par value per share, issued and 22,992,396 shares outstanding.

INDEX

	<u>PAGE NO.</u>
PART I	
	<u>FINANCIAL INFORMATION</u>
ITEM 1.	<u>Financial Statements (Unaudited)</u>
	<u>Consolidated Statements of Operations for the Three Months Ended August 31, 2006 and 2005</u>
	1
	<u>Consolidated Balance Sheets as of August 31, 2006 and May 31, 2006</u>
	2
	<u>Consolidated Statements of Cash Flows for the Three Months Ended August 31, 2006 and 2005</u>
	4
	<u>Consolidated Statements of Changes in Stockholders' Equity for the Three Months Ended August 31, 2006 and 2005</u>
	6
	<u>Notes to Consolidated Financial Statements</u>
	7
ITEM 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	21
ITEM 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	30
ITEM 4.	<u>Controls and Procedures</u>
	31
PART II	
	<u>OTHER INFORMATION</u>
ITEM 1.	<u>Legal Proceedings</u>
	32
ITEM 1A.	<u>Risk Factors</u>
	32
ITEM 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	32
ITEM 3.	<u>Defaults Upon Senior Securities</u>
	32
ITEM 4.	<u>Submission of Matters to a Vote of Security Holders</u>
	32
ITEM 5.	<u>Other Information</u>
	32
ITEM 6.	<u>Exhibits</u>
	33
	<u>Signature</u>
	33

PART I
FINANCIAL INFORMATION

ITEM 1. Financial Statements

Matrix Service Company
Consolidated Statements of Operations
(In thousands, except share and per share data)

	Three Months Ended	
	August 31, 2006	August 31, 2005
	(unaudited)	
Revenues	\$ 126,859	\$ 108,996
Cost of revenues	113,552	98,813
Gross profit	13,307	10,183
Selling, general and administrative expenses	7,684	7,207
Restructuring	—	322
Operating income	5,623	2,654
Other income (expense):		
Interest expense	(746)	(2,777)
Interest income	29	7
Other	104	730
Income before income taxes	5,010	614
Provision for federal, state and foreign income taxes	2,002	239
Net income	<u>\$ 3,008</u>	<u>\$ 375</u>
Basic earnings per common share	\$ 0.14	\$ 0.02
Diluted earnings per common share	\$ 0.12	\$ 0.02
Weighted average common shares outstanding:		
Basic	21,508,972	17,429,834
Diluted	26,547,276	17,654,336

See accompanying notes.

[Table of Contents](#)

Matrix Service Company
Consolidated Balance Sheets
(In thousands)

	August 31, 2006 (unaudited)	May 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	\$ 4,395	\$ 8,585
Accounts receivable, less allowances (August 31, 2006 - \$223 and May 31, 2006 - \$190)	56,050	64,061
Contract dispute receivables, net	11,684	11,668
Costs and estimated earnings in excess of billings on uncompleted contracts	34,564	24,538
Inventories	5,374	4,738
Income tax receivable	—	104
Deferred income taxes	2,850	2,831
Prepaid expenses	5,342	5,581
Assets held for sale	809	809
Total current assets	<u>121,068</u>	<u>122,915</u>
Property, plant and equipment at cost:		
Land and buildings	23,176	23,100
Construction equipment	33,153	31,081
Transportation equipment	11,738	10,921
Furniture and fixtures	8,707	8,658
Construction in progress	1,966	2,392
	<u>78,740</u>	<u>76,152</u>
Accumulated depreciation	(39,632)	(38,712)
	<u>39,108</u>	<u>37,440</u>
Goodwill	23,434	23,442
Other assets	5,729	4,479
Total assets	<u>\$ 189,339</u>	<u>\$ 188,276</u>

See accompanying notes.

Matrix Service Company
Consolidated Balance Sheets
(In thousands, except share data)

	August 31, 2006 (unaudited)	May 31, 2006
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 40,929	\$ 47,123
Billings on uncompleted contracts in excess of costs and estimated earnings	18,012	12,078
Income tax payable	1,885	—
Accrued insurance	6,423	6,408
Other accrued expenses	9,464	12,436
Current capital lease obligation	444	406
Current portion of acquisition payable	1,831	1,808
Total current liabilities	78,988	80,259
Long-term acquisition payable	2,611	2,578
Long-term capital lease obligation	512	538
Deferred income taxes	3,342	3,502
Convertible notes	15,000	25,000
Stockholders' equity:		
Common stock - \$.01 par value; 30,000,000 shares authorized; 24,686,782 and 22,595,243 shares issued as of August 31, 2006 and May 31, 2006	247	226
Additional paid-in capital	85,259	75,855
Retained earnings	7,305	4,316
Accumulated other comprehensive income	789	814
	93,600	81,211
Less: Treasury stock, at cost – 1,696,386 and 1,731,386 shares as of August 31, 2006 and May 31, 2006	(4,714)	(4,812)
Total stockholders' equity	88,886	76,399
Total liabilities and stockholders' equity	<u>\$ 189,339</u>	<u>\$ 188,276</u>

See accompanying notes.

Matrix Service Company
Consolidated Statements of Cash Flows
(In thousands)

	Three Months Ended	
	August 31, 2006	August 31, 2005
	(unaudited)	
Operating activities:		
Net income	\$ 3,008	\$ 375
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Depreciation and amortization	1,458	1,447
Deferred income tax	(179)	(97)
Gain on sale of property, plant and equipment	(97)	(720)
Allowance for uncollectible accounts	43	82
Stock-based compensation expense	180	—
Accretion on acquisition payable	56	76
Amortization of debt issuance costs	175	1,094
Amortization of prepaid interest	379	525
Changes in operating assets and liabilities increasing (decreasing) cash		
Receivables	7,952	12,352
Costs and estimated earnings in excess of billings on uncompleted contracts	(10,026)	(66)
Inventories	(636)	228
Prepaid expenses and other assets	(2,450)	140
Accounts payable	(5,897)	(3,513)
Billings on uncompleted contracts in excess of costs and estimated earnings	5,934	(471)
Accrued expenses	(2,957)	(5,806)
Income tax receivable/payable	1,989	1,157
Other	—	(6)
Net cash provided (used) by operating activities	<u>(1,068)</u>	<u>6,797</u>
Investing activities:		
Acquisition of property, plant and equipment	(3,305)	(939)
Proceeds from asset sales	115	2,163
Net cash provided (used) by investing activities	<u>\$ (3,190)</u>	<u>\$ 1,224</u>

Matrix Service Company
Consolidated Statements of Cash Flows (continued)
(In thousands)

	Three Months Ended	
	August 31, 2006	August 31, 2005
	(unaudited)	
Financing activities:		
Issuance of common stock	\$ 84	\$ 12
Advances under bank credit facility	28,105	40,027
Repayments of bank credit facility	(28,105)	(48,741)
Capital lease payments	(122)	(10)
Capital lease borrowings	—	181
Tax benefit of exercised stock options	120	—
Net cash provided (used) by financing activities	82	(8,531)
Effect of exchange rate changes on cash	(14)	131
Net decrease in cash and cash equivalents	(4,190)	(379)
Cash and cash equivalents, beginning of period	8,585	1,496
Cash and cash equivalents, end of period	<u>\$ 4,395</u>	<u>\$ 1,117</u>
Supplemental disclosure of cash flow information:		
Cash paid (received) during the period for:		
Income taxes	\$ 75	\$ (810)
Interest	\$ 170	\$ 962
Non-cash investing and financing activities:		
Equipment acquired through capital leases	\$ 135	\$ —
Purchases of property, plant and equipment on account	\$ 414	\$ —
Conversion of convertible notes	\$ 10,000	\$ 500

See accompanying notes.

Matrix Service Company
Consolidated Statements of Changes in Stockholders' Equity
(In thousands, except share data)
(unaudited)

	Common Stock	Additional Paid-In Capital	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)		Total
					Translation	Derivative	
Balances, May 31, 2006	\$ 226	\$ 75,855	\$ 4,316	\$(4,812)	\$ 814	\$ —	\$76,399
Net income	—	—	3,008	—	—	—	3,008
Other comprehensive income							
Translation adjustment	—	—	—	—	(25)	—	(25)
Comprehensive income							2,983
Conversion of convertible notes (2,091,539 shares)	21	9,099	—	—	—	—	9,120
Exercise of stock options (35,000 shares)	—	5	(19)	98	—	—	84
Stock based compensation expense	—	180	—	—	—	—	180
Tax effect of exercised stock options	—	120	—	—	—	—	120
Balances, August 31, 2006	<u>\$ 247</u>	<u>\$ 85,259</u>	<u>\$ 7,305</u>	<u>\$(4,714)</u>	<u>\$ 789</u>	<u>\$ —</u>	<u>\$88,886</u>
Balances, May 31, 2005	\$ 193	\$ 56,322	\$(3,307)	\$(5,201)	\$ 44	\$ (66)	\$47,985
Net income	—	—	375	—	—	—	375
Other comprehensive income							
Translation adjustment	—	—	—	—	304	—	304
Derivative activity	—	—	—	—	—	19	19
Comprehensive income							698
Conversion of convertible notes (95,854 shares)	1	418	—	—	—	—	419
Exercise of stock options (4,900 shares)	—	1	(2)	13	—	—	12
Tax effect of exercised stock options	—	5	—	—	—	—	5
Balances, August 31, 2005	<u>\$ 194</u>	<u>\$ 56,746</u>	<u>\$(2,934)</u>	<u>\$(5,188)</u>	<u>\$ 348</u>	<u>\$ (47)</u>	<u>\$49,119</u>

See accompanying notes.

Matrix Service Company
Notes to Consolidated Financial Statements
(unaudited)

Note 1 – Basis of Presentation

The consolidated financial statements include the accounts of Matrix Service Company (“Matrix Service” or the “Company”) and its subsidiaries, all of which are wholly owned. Intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X for interim financial statements required to be filed with the Securities and Exchange Commission and do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. However, the information furnished reflects all adjustments, consisting of normal recurring adjustments and other adjustments described herein that are, in the opinion of management, necessary for a fair statement of the results for the interim periods.

The accompanying financial statements should be read in conjunction with the audited financial statements for the year ended May 31, 2006, included in the Company’s Annual Report on Form 10-K for the year then ended. Matrix Service’s business is cyclical due to the scope and timing of projects released by its customer base. In addition, Matrix Service generates a significant portion of its revenues under a comparatively few major contracts which often do not commence or terminate in the same period from one year to the next. Accordingly, results for any interim period may not necessarily be indicative of future operating results.

Note 2 – Stock Based Compensation

Accounting for Stock Based Compensation

Prior to June 1, 2006, the Company accounted for stock options granted under its stock-based compensation plans (“Plans”) pursuant to the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations, as permitted by FASB Statement No. 123, “Accounting for Stock-Based Compensation” (SFAS No. 123). Compensation cost for stock options was not recognized in the Consolidated Statement of Operations for the three months ended August 31, 2005, as all options granted under the Plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. Effective June 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), using the modified-prospective method. Under this method, compensation cost recognized in the first quarter of fiscal 2007 includes compensation cost for all share-based awards granted through May 31, 2006 for which the requisite service period had not been completed as of May 31, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123. Results for prior periods have not been restated. Total stock-based compensation expense for the first quarter of fiscal 2007 was \$0.2 million. Measured but unrecognized stock-based compensation expense at August 31, 2006 was \$2.0 million, which is expected to be recognized as expense over a weighted average period of 2.17 years.

As a result of adopting SFAS No. 123(R), the Company’s net income for the quarter ending August 31, 2006 was \$0.2 million lower than if the Company had continued to account for share-based compensation under APB No. 25. Basic earnings per share were \$0.01 per share lower due to implementation of SFAS No. 123(R).

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

The following table illustrates the pro forma effect on net income and earnings per share for the quarter ended August 31, 2005 as if the Company had applied the fair value provisions of SFAS No. 123:

	<u>Three months ended</u> <u>August 31, 2005</u> <u>(In thousands, except</u> <u>per share amounts)</u>
Net income as reported	\$ 375
Pro forma compensation expense from stock options	117
Pro forma net income	<u>\$ 258</u>
Earnings per common share as reported:	
Basic	\$ 0.02
Diluted	\$ 0.02
Pro forma earnings per common share	
Basic	\$ 0.01
Diluted	\$ 0.01

Plan Information

The Company's 1990 Incentive Stock Option Plan (the "1990 Plan"), 1991 Incentive Stock Option Plan (the "1991 Plan"), and 2004 Stock Option Plan (the "2004 Plan") provide incentives for officers and other key employees of the Company. The Company also has a 1995 Nonemployee Directors' Stock Option Plan (the "1995 Plan"). Under the 2004 Plan, incentive and non-qualified stock options may be granted to the Company's key employees and non-qualified stock options may be granted to nonemployees who are elected for the first time as directors of the Company after January 1, 1991. Shareholders have authorized an aggregate of 1,800,000 options, 2,640,000 options, 500,000 options and 1,200,000 options to be granted under the 1990, 1991, 1995 and 2004 Plans, respectively. At August 31, 2006, there were 67,000 options and 1,047,242 options available for grant under the 1995 and 2004 Plans, respectively. There were no options available for grant under either the 1990 or 1991 Plans.

Stock Options

Stock options are valued at the date of award and compensation cost is recognized on a straight-line basis, net of estimated forfeitures, over the requisite service period. Employee stock options normally vest annually, in equal increments, over a five-year period beginning one year after the grant date. Options granted to non-employee directors normally vest annually, in equal installments, over a two-year period beginning one year after the grant date. Under all stock option plans, options cannot be granted for periods in excess of ten years. The option price per share may not be less than the fair market value of the common stock at the time the option is granted. The Company's policy is to issue shares upon the exercise of stock options from its treasury shares, if available.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

The following summary reflects stock option activity and related information for the quarter ended August 31, 2006:

<u>Stock Options</u>	<u>Options</u>	<u>Weighted-Average Exercise Price</u>	<u>Aggregate Intrinsic Value</u> (In thousands)
Outstanding at May 31, 2006	1,111,800	\$ 6.66	
Granted	—	\$ —	
Exercised	(35,000)	\$ 2.41	\$ 347
Cancelled	(7,200)	\$ 6.69	
Outstanding at August 31, 2006	<u>1,069,600</u>	<u>\$ 6.80</u>	<u>\$ 6,835</u>
Exercisable at August 31, 2006	<u>479,040</u>	<u>\$ 5.63</u>	<u>\$ 3,622</u>

The Company uses the Black-Sholes option pricing model to estimate grant date fair value for each stock option granted. Expected volatility is based on the historic volatility of the Company's stock. The risk-free rate is based on the applicable U.S. Treasury Note rate. The expected life of the option is based on historical and expected future exercise behavior.

The fair value of shares which became fully vested during the three months ended August 31, 2006 was less than \$0.1 million.

The following summary provides additional information about stock options that are outstanding and exercisable at August 31, 2006:

<u>Range of Exercise Prices</u>	<u>Stock Options Outstanding</u>			<u>Stock Options Exercisable</u>		
	<u>Options</u>	<u>Weighted-Average Exercise Price</u>	<u>Weighted-Average Remaining Contractual Life (Years)</u>	<u>Options</u>	<u>Weighted-Average Exercise Price</u>	<u>Weighted-Average Remaining Contractual Life (Years)</u>
\$ 1.81 - \$ 2.59	132,000	\$ 2.23	3.2	132,000	\$ 2.23	3.2
2.88 - 3.70	142,700	3.49	5.8	85,300	3.49	5.8
3.81 - 5.85	348,500	4.54	8.4	136,700	4.26	8.5
8.93 - 12.20	446,400	10.96	8.0	125,040	12.20	7.1
<u>\$ 1.81 - \$ 12.20</u>	<u>1,069,600</u>	<u>\$ 6.80</u>	<u>7.3</u>	<u>479,040</u>	<u>\$ 5.63</u>	<u>6.2</u>

Note 3 – Restructuring and Management Plans

On March 28, 2005, the Company initiated a restructuring program focused on reducing its cost structure, improving operating results, and improving liquidity. The Company refocused on its core strengths and eliminated unprofitable and marginal work in under-performing areas. As a result of this effort, the Company identified certain assets for disposition including selected transportation and rigging assets, the aluminum floating roof business as well as excess facilities and/or land in Tulsa, Oklahoma; Orange, California; and Holmes, Pennsylvania. The details of asset dispositions are further discussed in Note 4. Matrix Service also ceased work on a number of large routine maintenance contracts that were utilizing valuable resources while providing minimal returns. The Company has substantially completed its restructuring program including the issuance of convertible notes (discussed in Note 5), completion of a private placement of common stock (discussed in Note 6) and refinancing of its senior credit facility (discussed in Note 5).

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Restructuring activities other than asset sales and debt refinancing of the Company consist of the following:

	<u>Employee Severance Benefits</u>	<u>Consulting Fees</u>	<u>Other Costs</u>	<u>Total</u>
	(In thousands)			
Liability balance at May 31, 2006	\$ —	\$ —	\$559	\$ 559
Charge to income	—	—	—	—
Payments	—	—	(14)	(14)
Liability balance at August 31, 2006	<u>\$ —</u>	<u>\$ —</u>	<u>\$545</u>	<u>\$ 545</u>
Liability balance at May 31, 2005	\$ 892	\$ 425	\$542	\$1,859
Charge to income	65	257	—	322
Payments	(580)	(257)	(60)	(897)
Liability balance at August 31, 2005	<u>\$ 377</u>	<u>\$ 425</u>	<u>\$482</u>	<u>\$1,284</u>

During the first quarter of fiscal 2007, the Company made payments of less than \$0.1 million. These payments relate primarily to environmental monitoring costs incurred in connection with a business previously disposed.

During the first quarter of fiscal 2006, the Company charged \$0.3 million of restructuring related costs against earnings. These restructuring charges were primarily related to additional professional fees incurred in connection with the restructuring activities and additional employee severance and benefit costs. These restructuring charges are reflected in the applicable segment in Note 13. "Other" restructuring charges are allocated based on percentage of revenue. Payments of \$0.9 million were made during the three months ended August 31, 2005.

Restructuring liabilities are included in other accrued expenses in the Company's Consolidated Balance Sheets.

Note 4 – Property Sales and Assets Held for Sale

As part of the Company's restructuring efforts discussed in Note 3, certain assets have been sold or identified for sale.

Asset Sales

In the first quarter of fiscal 2006, the Company sold a fabrication facility in Tulsa, Oklahoma which was no longer being utilized, for \$0.7 million, which was equal to the book value of the asset. The asset was previously classified as held for sale.

In addition, in the first quarter of fiscal 2006 the Company sold excess construction equipment for net proceeds of \$1.7 million, including \$0.2 million for services to be provided in the future. The sale resulted in a gain of approximately \$0.6 million. These services were substantially complete at August 31, 2006.

In the second quarter of fiscal 2006, the Company sold a fabrication facility and land in Holmes, Pennsylvania for \$0.7 million. The asset was previously classified as held for sale and the sale resulted in a gain of approximately \$0.4 million.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Also, in the second quarter of fiscal 2006, the Company completed the sale of its Bethlehem, Pennsylvania fabrication facility for \$3.5 million, \$0.5 million of which was in the form of a promissory note which bears interest at 12% per annum. Principal and interest on the note is payable in equal monthly installments over 60 months beginning in January 2006. The Company may also earn an additional \$0.2 million based upon the earnings of the buyer. In the event the buyer chooses to prepay the remaining deferred obligation, which the buyer may do at any time without penalty, the additional earnout opportunity would be eliminated. The sale consisted of assets of \$4.1 million, including goodwill of \$1.5 million, liabilities of \$1.0 million and resulted in a gain of \$0.4 million.

In the third quarter of fiscal 2006, the Company sold and subsequently leased-back its corporate facility. The net proceeds from the sale were \$0.7 million. No gain or loss was recognized on the sale, as the facility was previously impaired \$0.1 million in the second quarter of fiscal 2006 to adjust the carrying value of the facility to the estimated sale proceeds.

Assets Held for Sale

In fiscal 2005, the Company identified various assets as available for sale under the current business plan. Certain of these assets were sold in fiscal 2006, as discussed above. The Company still holds excess land located in Orange, California, for which a sale is pending. The carrying value of the excess land at August 31, 2006 was \$0.8 million, which approximates the expected net proceeds from the pending sale. The land is classified as a current asset held for sale in the Consolidated Balance Sheets and is reflected in the Company's "Other" segment in Note 13.

Note 5 – Debt

Debt consisted of the following:

	<u>August 31,</u> <u>2006</u>	<u>May 31,</u> <u>2006</u>
	<u>(In thousands)</u>	
Debt outstanding:		
Senior credit facility - revolver	\$ —	\$ —
Convertible notes	15,000	25,000
Total debt	<u>\$ 15,000</u>	<u>\$ 25,000</u>

Senior Credit Facility

The Company's Amended and Restated Credit Agreement (Credit Agreement) provides for a \$40 million revolving credit facility. The revolving credit facility may be used for working capital, issuance of letters of credit or other lawful corporate purposes. Availability under the revolving facility is governed by a borrowing base equal to 80% of outstanding accounts receivable less certain exclusions as defined in the Credit Agreement and is further reduced by outstanding letters of credit. On August 31, 2006, availability under the revolving credit facility was \$23.4 million, which represents amounts available under the borrowing base of \$34.5 million less outstanding letters of credit of \$11.1 million. The terms and conditions of the Credit Agreement include customary affirmative and negative covenants, with which the Company was in compliance at August 31, 2006.

At the Company's option, amounts borrowed under the revolving credit facility will bear interest at LIBOR or an alternate base rate, plus in each case an additional margin based on the Senior Leverage Ratio. The alternate base rate is the greater of the prime rate or the fed funds effective rate plus 0.5%. The additional margin ranges from 0.75% to 2.00% on alternate base rate borrowings and from 2.25% to 3.50% on LIBOR-based borrowings. Based upon the terms of the Credit Agreement, the Company may currently borrow in the lowest interest rate tier, resulting in LIBOR and alternative base rate margins of 2.25% and 0.75%, respectively.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

The Credit Agreement contains certain provisions that limit the Company's ability to incur additional indebtedness and impose restrictions on capital expenditures. These provisions limit outstanding capital and operating lease obligations to \$12.5 million at any time with a maximum of \$3.5 million in operating lease payments in any fiscal year. Additional restrictions include a limit on capital expenditures of \$12.5 million per fiscal year and a limit on other unsecured indebtedness of \$1.5 million.

The Credit Agreement is guaranteed by all of our subsidiaries and is secured by a lien on substantially all of our assets.

Convertible Debt

In connection with the private placement of \$30 million of five-year convertible notes, on April 25, 2005, we entered into a registration rights agreement with the investors in the convertible notes. The registration rights agreement requires us to use our best efforts to keep our registration statement, covering the resale of the shares of our common stock issuable upon conversion of the convertible notes, continuously effective until the earlier of (a) the date on which all of our common stock covered by such registration statement has been sold or may be sold without volume restrictions pursuant to Rule 144(k) under the Securities Act of 1933, as amended, or (b) the fifth anniversary of the closing date. If we fail to satisfy our obligations under the registration rights agreement, we will owe the holders of the convertible notes as partial liquidated damages an amount in cash equal to 1% of the aggregate amount paid for the convertible notes for each such event, and thereafter on each monthly anniversary of each such event (if the applicable failure shall not have been cured by such date) until the applicable failure is cured, we will owe the note holders an amount in cash equal to an additional 1% of the aggregate amount paid for the convertible notes.

The convertible notes were issued under a securities purchase agreement among the Company and certain investors, and bear interest at a rate of 7% per year. Beginning on June 30, 2007, the convertible notes will bear interest at a rate of 5% per year if certain conditions defined in the registration rights agreement are met. The notes are convertible into shares of the Company's common stock at an initial conversion price of \$4.69 per share, subject to adjustment for stock dividends, stock splits or other matters as provided for in the securities purchase agreement. An initial interest pre-payment of \$4.2 million was made on April 25, 2005 for the period to and including April 25, 2007. Prepaid interest of \$0.7 million is included in prepaid assets at August 31, 2006. Interest is payable in arrears on each March 31, June 30, September 30 and December 31, beginning on June 30, 2007, through the date of maturity.

The securities purchase agreement requires us to maintain certain financial ratios. It also limits the amount of senior obligations permitted under the senior credit facility or the refinancing or replacement thereof, including new and replacement letters of credit, to \$90 million; limits capital lease obligations to \$12.5 million, limits operating leases to \$15 million, limits purchase money financing to \$1 million and limits debt under the Company's performance and bonding line to \$150 million. The Company is currently in compliance with all terms and covenants of the securities purchase agreement.

In fiscal 2006, \$5.0 million of the convertible notes were converted by note holders into 1,002,275 shares of the Company's Common Stock and on August 3, 2006, an additional \$10.0 million of the convertible notes were converted into 2,091,539 shares. As of August 31, 2006, \$15.0 million of the convertible notes remained outstanding.

Note 6 – Private Placement of Common Stock

On October 3, 2005, the Company completed a private placement of approximately 2.3 million shares of common stock. The common stock was priced at \$6.50 per share. The net proceeds from the issuance were approximately \$14.9 million. The Company used the proceeds to repay a portion of its outstanding balance on the Company's revolving line of credit in order to provide additional liquidity for working capital needs.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

In connection with the private placement of common stock, on October 3, 2005, the Company entered into a registration rights agreement with the purchasers of the common stock. The registration rights agreement required us to file a registration statement with respect to the resale of the shares of the common stock issued in the private placement. The registration statement was filed with the SEC on October 20, 2005 and was declared effective by the SEC on October 28, 2005. The registration rights agreement also requires us to use our best efforts to keep the registration statement continuously effective until the earlier of (a) the date on which all of the common stock covered by such registration statement has been sold or may be sold without volume restrictions pursuant to Rule 144(k) under the Securities Act of 1933, as amended, or (b) the fifth anniversary of the date the registration statement is declared effective by the SEC. If we fail to satisfy our obligations under the registration rights agreement, we will owe the holders of the common stock as partial liquidated damages an amount in cash equal to 1% of the aggregate amount paid for the common stock for each such event, and thereafter on each monthly anniversary of each such event (if the applicable failure shall not have been cured by such date) until the applicable failure is cured, we will owe the note holders an amount in cash equal to an additional 1% of the aggregate amount paid for the common stock.

Note 7 – Acquisition Payable

As part an acquisition in fiscal 2003, the Company entered into an acquisition payable for a portion of the purchase price. The acquisition payable is recorded at \$4.4 million at August 31, 2006 and is accreted for the change in its present value each period utilizing a 5.1% effective interest rate. Payments related to the acquisition payable are due annually on March 7, with \$1.9 million and \$2.8 million due in 2007 and 2008, respectively.

Pursuant to the purchase agreement, the former shareholders of the acquired entity agreed, jointly and severally, to indemnify Matrix Service for damages it suffers due to breaches of representations and warranties made by the shareholders with respect to, among other things, its employee benefit plans, the ownership, use and condition of its assets and the performance by the acquired company of its contractual obligations and its obligations under applicable laws, including employment and environmental laws. As to these matters, Matrix Service may recover its damages only if its claims for damages are made by March 7, 2008, the amount of damages claimed as to any single event exceeds a de minimus amount of \$10,000, and only after the aggregate amount of all such claims excluding de minimus claims exceeds \$250,000. In order to better assure the payment to Matrix Service of any claims by it for indemnity, \$10.0 million of the purchase price was withheld in the form of a deferred purchase price payable to the former shareholders or their designee. Upon final determination that a claim for indemnity is proper, the amount of the claim can be deducted by Matrix Service from the deferred payments of the purchase price. Since the purchase date on March 7, 2003, claims have not exceeded \$250,000, and thus no adjustment to the deferred purchase price has been made related to these provisions as of August 31, 2006.

Note 8 – Income Taxes

Deferred income taxes are computed using the liability method whereby deferred tax assets and liabilities are recognized based on temporary differences between the financial statement and tax basis of assets and liabilities using presently enacted tax rates. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for income tax purposes.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Note 9 – Contract Disputes

	<u>As of August 31, 2006</u>		<u>As of May 31, 2006</u>	
	<u>Total Claim</u>	<u>Net Receivable</u>	<u>Total Claim</u>	<u>Net Receivable</u>
	(In thousands)			
Contract Dispute I	\$ —	\$ —	\$ —	\$ —
Contract Dispute II	16,924	11,298	16,566	11,298
Contract Dispute III	5,758	4,199	5,758	4,183
Contract Dispute IV	2,054	975	2,054	975
Contract Dispute V	3,186	602	3,186	602
Contract Dispute Reserve	—	(5,390)	—	(5,390)
Total	<u>\$ 27,922</u>	<u>\$ 11,684</u>	<u>\$ 27,564</u>	<u>\$ 11,668</u>

Contract Dispute I - Settled

On December 21, 2005, the Company agreed to settle a previous contract dispute for \$10.0 million, which was collected in the third quarter of fiscal 2006. No gain or loss was recognized as the amount of the settlement approximated the net receivable balance.

Contract Dispute II

In the fourth quarter of fiscal 2003, a subsidiary of the Company was subcontracted by a general contractor (GC) to erect two Selective Catalytic Reactor (SCR) Units for an owner. The Company had performed all of its obligations to the GC in accordance with the parties' Subcontractor Agreement, along with significant extra work that the GC directed the Company to perform to cure design defects, mis-fabrications, and project delays attributable to the GC. The GC refused to sign certain change orders for the additional work performed and alleged that the services and materials provided by the Company were defective and behind schedule. In June 2004, the owner terminated the GC for cause. The owner subsequently retained the Company to complete the project. The owner refused to pay the Company the amounts owed by the GC because the owner had previously paid the GC for the work. The Company has subsequently completed work on the SCR units to the satisfaction of the owner. Under the terms of the owner's original contract with the GC, the GC provided the owner with an unconditional and irrevocable guarantee of its parent, a non-USA based holding company. Under this guarantee, the parent guaranteed the GC's performance and payment obligations, including the obligations that the GC owed to the Company and other subcontractors.

On December 22, 2005, the Company was granted an interim arbitration award of \$10.3 million plus interest and certain fees, including legal fees incurred in connection with the dispute. Under the terms of the arbitration award, the Company was directed to submit itemized statements of its attorney fees and other costs. A final arbitration award of \$12.1 million was granted on March 20, 2006. Interest will accrue at approximately \$3,000 per day until the award is paid. The GC has formally objected to the award. The Company is taking the appropriate steps to have the award confirmed in order to enforce and collect the award.

Contract Dispute III

In fiscal year 2003, two of the Company's subsidiaries entered into sub-subcontract agreements with another subcontractor (Sub) to provide all necessary supervision, labor, materials, and equipment necessary to install a heater foundation, on a time and material basis at an owner's facility. The Sub was previously contracted by the general contractor (GC) on the project, to perform foundation installation, equipment, piping and steel erection, other construction work and construction management. As the project progressed, the Sub opted to increase the Company's subsidiaries' scope of work.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

On September 30, 2003, the Sub filed for Chapter 11 bankruptcy protection. At the date of the bankruptcy filing, the Company's subsidiaries had substantially completed all work at the job site. Subsequent to the Sub's bankruptcy filing, the GC assumed all of the Sub's obligations that are subject to valid liens associated with the project. The Company's subsidiaries subsequently filed valid construction lien claims totaling approximately \$5.8 million against the owner, GC and Sub. These lien claims have been fully bonded by the GC, although the GC disputes the lien amounts and seeks to have a smaller lien fund fixed. Therefore, the Company is not required to proceed through the Sub's bankruptcy proceedings to collect amounts owed. The Court has ruled on the standards to be applied in the computation of the "lien fund" that is available to satisfy the liens that have been asserted against the project. Currently, the Company is in dispute with the owner and the GC as to the appropriate calculation of the available lien fund. Court-ordered mediation has to date been unsuccessful in enabling the parties to reach a settlement. The Company believes that it has a valid claim and that the value of the lien fund will be established at an amount adequate to fund the associated claim by the Company. The Company expects a full resolution of this matter to occur within fiscal 2007.

Contract Dispute IV

In March 2000, the Company entered into a joint venture partnership (JV) agreement for the construction of a pulp and paper project for an owner, which was completed late in 2000. The services provided by the JV consisted primarily of a labor contract with the owner supplying the engineering and the majority of the materials to be installed. The claim arises out of a contractual dispute in which the Company believes the JV incurred substantial work because the owner's planning and engineering on the project was not adequate. The owner did not pay amounts owed and claims that the JV was not properly licensed by the Oregon Contractors Licensing Board, and therefore not eligible to file a lawsuit under Oregon law. An Oregon state court ruled in favor of the owner regarding the licensing issue and the Company appealed the decision.

The Oregon Court of Appeals subsequently ruled that the dispute should be settled in arbitration. That ruling has been upheld by the Oregon Supreme Court. The Company will proceed with arbitration and expects a full resolution of this matter to occur within the next twelve months.

Contract Dispute V

A subsidiary of the Company performed work from May 2005 to August 2005 under a subcontract with a general contractor (GC). As the project progressed, the Company asserted claims for impacts and delays attributable to the GC's numerous change orders and project acceleration. As a result, the GC terminated the Company from the project when the project was more than 60% complete. The Company subsequently de-mobilized from the site. The Company believes it has valid claims for amounts owed and that it is adequately reserved for the dispute.

Contract Dispute Reserve

In addition to reserves recorded within each cash dispute, the Company maintains a contract dispute reserve. As of August 31, 2006, the contract dispute reserve balance is \$5.4 million. The Company believes it is adequately reserved for the disputes and the collection risk of settlements, mediation and arbitration awards. The Company routinely assesses the adequacy of the contract dispute reserve. As additional information becomes available, including settlements and the collection of settlements, the Company will evaluate and adjust the reserve, if necessary.

Note 10 – Contingencies

Insurance Reserves

The Company maintains insurance coverage for various aspects of our operations. However, the Company retains exposure to potential losses through the use of deductibles, coverage limits, self-insured retentions and insurer viability.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Typically the Company's contracts require an indemnification to customers for injury, damage or loss arising from the performance of our services and provide for warranties for materials and workmanship. The Company may also be required to name the customer as an additional insured under certain insurance policies up to the limits of insurance available to the Company and may have to purchase special insurance policies or surety bonds for specific customers. Matrix Service generally requires its subcontractors to indemnify the Company and the Company's customer plus name the Company as an additional insured for activities arising out of the subcontractors' presence at the customer's location. Certain subcontractors also have to provide additional insurance policies, including surety bonds in favor of the Company, to secure the subcontractors work or as required by the subcontract. Matrix Service maintains a performance and payment bonding line of \$54.0 million.

There can be no assurance that the Company's insurance and the additional insurance coverage provided by subcontractors will protect against a valid claim or loss under the contracts with customers.

Legion Insurance Dispute

Matrix Service, as plaintiff, is currently in litigation in the Tulsa County District Court in the State of Oklahoma over matters arising out of a workers' compensation program with a former insurance provider, Legion Insurance Company ("Legion"). These matters involve contests over a letter of credit ("LC") for \$2.2 million, a bond for \$2.1 million and a deposit of \$1.0 million pledged to secure Matrix Service's obligations under this program. As a part of its insurance program, Legion used an offshore insurance company, Mutual Indemnity ("Mutual"). Matrix Service purchased preferred stock in Mutual, which then reinsured part of the workers' compensation exposure that was underwritten by Legion.

On April 1, 2002, the Insurance Commissioner for the State of Pennsylvania placed Legion into rehabilitation. Matrix Service was concerned that the security held by Mutual would be commingled with other shareholder assets and not used exclusively to pay Matrix Service claims. Matrix Service filed suit in the Tulsa County District Court to require a full accounting of all funds held by Mutual and restrain Mutual from drawing on the LC or surety bond. The court granted a temporary restraining order prohibiting the use of such assets for the payment of claims other than Matrix Service claims.

On July 25, 2003, a Pennsylvania court placed Legion into liquidation. At that time, all open workers' compensation claims were sent to the various state guaranty funds for handling. Many of the states have denied responsibility with respect to Matrix Service claims because Matrix Service's net worth exceeded the statutory maximum as of December 31, 2002, the year preceding the Legion liquidation, under which claims would be handled by the individual state guaranty funds. Those states returned the claims back to Matrix Service for direct handling. In other states where Matrix Service has exposure, the state guaranty funds took over the claims.

Matrix Service is continuing to negotiate with Legion Insurance Company for a settlement of all obligations resulting from workers' compensation claim payments made on Matrix Service's behalf by Legion itself, and by the various state guaranty funds that are seeking reimbursement from Legion. Once that obligation has been satisfied, Matrix Service will work with Mutual to dismiss the lawsuit, eliminate Mutual's rights under the LC and surety bond and return a portion of the cash deposit. Matrix Service cannot predict when a final settlement will be reached due to Legion's inability to quantify claim payments it made on Matrix Service's behalf. The Company believes its \$2.7 million reserve on this matter is adequate to cover claim settlements with the state guaranty funds and Legion.

Refinery Accident

On November 6, 2005, two employees of the Company were fatally injured in an accident that occurred at a customer jobsite in Delaware City, Delaware. The estates of both families have filed liability claims against the property owner. These claims have been tendered by the property owner to the Company for defense. The Company believes that it is adequately reserved or insured for this incident and any losses incurred are not expected to be significant.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Unapproved Change Orders and Claims

As of August 31, 2006 and May 31, 2006, accounts receivable and costs and estimated earnings in excess of billings on uncompleted contracts included revenues, to the extent of costs incurred, for unapproved change orders of \$3.8 million and claims of approximately \$0.4 million and \$0.5 million, respectively.

Amounts disclosed for unapproved change orders and claims exclude amounts associated with contract disputes disclosed in Note 9 – Contract Disputes. Generally, collection of amounts related to unapproved change orders and claims is expected within twelve months. However, customers generally will not pay these amounts to Matrix Service until final resolution of related claims, and accordingly, collection of these amounts may extend beyond one year.

Other

The Company and its subsidiaries are named as defendants in various other legal actions and are vigorously defending against each of them. In the opinion of management, none of such legal actions will have a material effect on the Company's financial position, results of operations or liquidity.

Note 11 – Accumulated Other Comprehensive Income

Other comprehensive income and accumulated other comprehensive income consisted of foreign currency translation adjustments and fair value adjustments of derivative instruments.

	Three Months Ended	
	<u>August 31, 2006</u>	<u>August 31, 2005</u>
	(In thousands)	
Net income	\$ 3,008	\$ 375
Other comprehensive income	(25)	323
Comprehensive income	<u>\$ 2,983</u>	<u>\$ 698</u>

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Note 12 – Earnings Per Common Share

Basic earnings per share (EPS) is calculated based on the weighted average shares outstanding during the period. Diluted earnings per share includes the dilutive effect of employee and director stock options, as well as the dilutive effect of convertible securities. Stock options are considered antidilutive whenever the exercise price of the options exceed the average market price of the common stock during the period. Convertible debt is considered antidilutive whenever its interest (net of tax) per common share obtainable on conversion exceeds basic earnings per share. Stock options are considered dilutive whenever the exercise price is less than the average market price of the stock during the period. Dilutive convertible securities are calculated using the “if converted” method, in which all unconverted securities are assumed to be converted as of the beginning of the period. The “if converted” method also requires that any interest charges, net of tax, applicable to the securities be added back to net income for purposes of computing diluted earnings per share. Both stock options and convertible debt are considered antidilutive in the event of a net loss.

Antidilutive options for the three-month periods ending August 31, 2006 and August 31, 2005 were 416,400 and 290,028, respectively. These options were not included in the calculation of diluted earnings per share.

The computation of basic and diluted EPS is as follows:

	Three Months Ended	
	August 31, 2006	August 31, 2005
(In thousands, except share and per share data)		
Basic EPS:		
Net income (loss)	\$ 3,008	\$ 375
Weighted average shares outstanding	21,508,972	17,429,834
Basic EPS	\$ 0.14	\$ 0.02
Diluted EPS:		
Net income	\$ 3,008	\$ 375
Convertible notes interest expense (net of tax)	262	—
Adjusted net income (loss)	\$ 3,270	\$ 375
Weighted average shares outstanding - basic	21,508,972	17,429,834
Dilutive stock options	356,743	224,502
Dilutive convertible note shares	4,681,561	—
Dilutive weighted average shares	26,547,276	\$ 17,654,336
Diluted EPS	\$ 0.12	\$ 0.02

The convertible notes were antidilutive for the three months ended August 31, 2005; therefore, they did not impact earnings per share.

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Note 13 – Segment Information

The Company has two reportable segments, the Construction Services segment and the Repair and Maintenance Services segment.

The Construction Services segment provides turnkey construction, civil construction, structural steel erection, mechanical installation, process piping, electrical and instrumentation, fabrication, vessel and boiler erection, millwrighting, plant modifications, centerline turbine erection, and startup and commissioning. In addition, design, engineering, fabrication and construction of aboveground storage tanks are offered.

The Repair and Maintenance Services segment provides outage and turnaround services, plant maintenance, electrical and instrumentation maintenance, tank inspection, repair and maintenance, industrial cleaning, and American Society of Mechanical Engineers (ASME) code repairs.

Other consists of items related to previously disposed of businesses and unallocated corporate assets.

The Company evaluates performance and allocates resources based on profit or loss from operations before income taxes. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies included in the Company's Annual Report on Form 10-K for the year ended May 31, 2006. Intersegment sales and transfers are recorded at cost and there is no intercompany profit or loss on intersegment sales or transfers.

Segment assets consist of accounts receivable, costs and estimated earnings in excess of billings on uncompleted contracts, property, plant and equipment and goodwill.

Restructuring charges are reflected in the applicable segment. "Other" restructuring, impairment and abandonment charges are allocated to the Construction Services and Repair and Maintenance Services segments based on percentage of revenue.

Results of Operations

	<u>Construction Services</u>	<u>Repair & Maintenance Services</u>	<u>Other</u>	<u>Combined Total</u>
	(In thousands)			
Three Months ended August 31, 2006				
Gross revenues	\$ 78,991	\$ 50,428	\$ —	\$ 129,419
Less: Inter-segment revenues	2,182	378	—	2,560
Consolidated revenues	76,809	50,050	—	126,859
Gross profit	8,447	4,860	—	13,307
Operating income	4,291	1,332	—	5,623
Income before income tax expense	3,711	1,299	—	5,010
Net income	2,227	781	—	3,008
Segment assets	100,814	66,374	22,151	189,339
Capital expenditures	2,272	762	271	3,305
Depreciation and amortization expense	799	659	—	1,458
Three Months ended August 31, 2005				
Gross revenues	\$ 64,245	\$ 46,936	\$ —	\$ 111,181
Less: Inter-segment revenues	2,030	155	—	2,185
Consolidated revenues	62,215	46,781	—	108,996
Gross profit	6,441	3,742	—	10,183
Operating income (loss)	2,585	244	(175)	2,654
Income (loss) before income tax expense	1,130	(341)	(175)	614
Net income (loss)	696	(213)	(108)	375
Segment assets	98,338	64,356	21,693	184,387
Capital expenditures	347	426	166	939
Depreciation and amortization expense	700	747	—	1,447

Matrix Service Company
Notes to Consolidated Financial Statements (continued)

Segment Revenue from External Customers by Industry Type

	<u>Construction Services</u>	<u>Repair & Maintenance Services</u> (In thousands)	<u>Total</u>
Three Months Ended August 31, 2006			
Downstream Petroleum Industry	\$ 54,435	\$ 48,311	\$102,746
Power Industry	4,884	1,223	6,107
Other Industries ⁽¹⁾	17,490	516	18,006
Total	<u>\$ 76,809</u>	<u>\$ 50,050</u>	<u>\$126,859</u>
Three Months Ended August 31, 2005			
Downstream Petroleum Industry	\$ 50,435	\$ 43,222	\$ 93,657
Power Industry	3,544	2,870	6,414
Other Industries ⁽¹⁾	8,236	689	8,925
Total	<u>\$ 62,215</u>	<u>\$ 46,781</u>	<u>\$108,996</u>

⁽¹⁾ Other Industries consists primarily of liquefied natural gas, wastewater, food and beverage, manufacturing and paper industries.

[Table of Contents](#)

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

Critical Accounting Policies

The following is a discussion of the most critical accounting policies, judgments and uncertainties that are inherent in our application of generally accepted accounting principles (GAAP).

Revenue Recognition

Matrix Service records profits on long-term contracts on a percentage-of-completion basis on the cost-to-cost method. Contracts in process are valued at cost plus accrued profits less billings on uncompleted contracts. Contracts are generally considered substantially complete when field construction is completed. The elapsed time from award of a contract to completion of performance may be in excess of one year. Matrix Service includes pass-through revenue and costs on cost-plus contracts, which are customer-reimbursable materials, equipment and subcontractor costs, when Matrix Service determines that it is responsible for the procurement and management of such cost components on behalf of the customer.

Matrix Service has numerous contracts that are in various stages of completion. Such contracts require estimates to determine the appropriate cost and revenue recognition. Matrix Service has a history of making reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs, and accordingly, does not believe significant fluctuations are likely to materialize. However, current estimates may be revised as additional information becomes available. If estimates of costs to complete long-term contracts indicate a loss, provision is made through a contract write-down for the total loss anticipated. A number of our contracts contain various cost and performance incentives and penalties that impact the earnings we realize from our contracts, and adjustments related to these incentives and penalties are recorded in the period when estimable or finalized, which is generally during the latter stages of the contract. Contract incentives are evaluated throughout the life of the contract and are recognized on a percentage-of-completion basis when the likelihood of obtaining the incentive becomes probable.

Indirect costs (such as salaries and benefits, supplies and tools, equipment costs and insurance costs) are charged to projects based upon direct labor hours and overhead allocation rates per direct labor hour. Warranty costs are normally incurred prior to project completion and are charged to project costs as they are incurred. Warranty costs incurred subsequent to project completion were not material for the periods presented. Overhead allocation rates are established annually during the budgeting process and evaluated for accuracy throughout the year based upon actual direct labor hours and actual costs incurred.

Matrix Service records revenue on reimbursable and time and material contracts based on a proportional performance basis as costs are incurred.

Claims Recognition

Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that we seek to collect from customers or others for delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price or other causes of anticipated additional costs incurred by us. Recognition of amounts as additional contract revenue related to claims is appropriate only if it is probable that the claims will result in additional contract revenue and if the amount can be reliably estimated. We must determine if:

- there is a legal basis for the claim;
- the additional costs were caused by circumstances that were unforeseen by the Company and are not the result of deficiencies in our performance;
- the costs are identifiable or determinable and are reasonable in view of the work performed; and
- the evidence supporting the claim is objective and verifiable.

[Table of Contents](#)

If all of these requirements are met, revenue from a claim is recorded only to the extent that we have incurred costs relating to the claim.

As of August 31, 2006 and May 31, 2006, accounts receivable and costs and estimated earnings in excess of billings on uncompleted contracts included revenues, to the extent of costs incurred, for unapproved change orders of approximately \$3.8 million and claims of approximately \$0.4 million and \$0.5 million, respectively. Historically, our collections for unapproved change orders and other claims have approximated the amount of revenue recognized.

The following table provides a rollforward of revenue recognized on claims and unapproved change orders. Amounts disclosed for unapproved change orders exclude amounts associated with contract disputes disclosed in Note 9 – Contract Disputes:

	<u>Claims for Unapproved Change Orders</u>	<u>Other Claims</u> (In thousands)	<u>Total</u>
Balance at May 31, 2006	\$ 3,845	\$ 523	\$4,368
Additions	—	—	—
Collections	(10)	(66)	(76)
Loss	—	(31)	(31)
Balance at August 31, 2006	<u>\$ 3,835</u>	<u>\$ 426</u>	<u>\$4,261</u>
Balance at May 31, 2005	\$ 208	\$ 383	\$ 591
Additions	150	13	163
Collections	(183)	—	(183)
Gain	12	—	12
Balance at August 31, 2005	<u>\$ 187</u>	<u>\$ 396</u>	<u>\$ 583</u>

Contract Dispute Receivables

Contract Dispute Receivables are comprised of accounts receivable and cost and estimated earnings in excess of billings for which settlement is only expected to occur through legal proceedings such as mediation, arbitration or litigation. Such proceedings have resulted in delays in obtaining resolution. As a result, the balances are presented separately on the balance sheet at estimated net realizable value based upon the most current information available. Amounts ultimately received may differ from the current estimate.

Loss Contingencies

Various legal actions, claims, and other contingencies arise in the normal course of our business. Contingencies are recorded in the consolidated financial statements, or are otherwise disclosed, in accordance with SFAS No. 5 “Accounting for Contingencies”. Specific reserves are provided for loss contingencies to the extent we conclude their occurrence is both probable and estimable. We use a case-basis evaluation of the underlying data and update our evaluation as further information becomes known. We believe that any amounts exceeding our recorded accruals should not materially affect our financial position, results of operations or liquidity. However, the results of litigation are inherently unpredictable and the possibility exists that the ultimate resolution of one or more of these matters could result in a material adverse effect on our financial position, results of operations or liquidity.

Legal costs are expensed as incurred.

[Table of Contents](#)

Insurance Reserves

We maintain insurance coverage for various aspects of our operations. However, we retain exposure to potential losses through the use of deductibles, coverage limits and self-insured retentions. As of August 31, 2006 and May 31, 2006, insurance reserves totaling \$6.4 million are reflected on our balance sheet. These amounts represent our best estimate of our ultimate obligations for asserted claims plus claims incurred but not yet reported at the balance sheet date. We establish specific reserves for claims using a case by case evaluation of the underlying claim data and update our evaluations as further information becomes known. Judgments and assumptions are inherent in our reserve accruals; as a result, changes in assumptions or claims experience could result in changes to these estimates in the future. Additionally, the actual results of claim settlements could differ from the amounts estimated.

Goodwill

Goodwill and intangible assets with indefinite useful lives are not amortized and are tested at least annually for impairment. Goodwill represents the excess of the purchase price of acquisitions over the fair value of the net assets acquired. Goodwill is evaluated for impairment by first comparing management's estimate of the fair value of a reporting unit with its carrying value, including goodwill. Reporting units for purposes of goodwill impairment calculations are our reportable segments.

Management utilizes a discounted cash flow analysis to determine the estimated fair value of our reporting units. Judgments and assumptions related to revenue, gross margins, operating expenses, interest, capital expenditures, cash flow and market assumptions are inherent in these estimates. As a result, use of alternate judgments and/or assumptions could result in a fair value that differs from our estimate and ultimately results in the recognition of impairment charges in the financial statements. We utilize various assumption scenarios and assign probabilities to each of these scenarios in our discounted cash flow analysis. The results of the discounted cash flow analysis are then compared to the carrying value of the reporting unit.

If the carrying value of a reporting unit exceeds its fair value, a computation of the implied fair value of goodwill is compared with its related carrying value. If the carrying value of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in the amount of the excess. If an impairment charge is incurred, it would negatively impact our results of operations and financial position. We perform our annual analysis during the fourth quarter of each fiscal year and in any other period in which indicators of impairment warrant an additional analysis.

Results of Operations

Overview

The Company has two reportable segments, Construction Services and Repair and Maintenance Services. The majority of the work for both segments is performed in the United States with only a minimal amount occurring in Canada.

The Construction Services segment provides turnkey construction, civil construction, structural steel erection, mechanical installation, process piping, electrical and instrumentation, fabrication, vessel and boiler erection, millwrighting, plant modifications, centerline turbine erection, and startup and commissioning. In addition, design, engineering, fabrication and construction of aboveground storage tanks are offered.

The Repair and Maintenance Services segment provides outage and turnaround services, plant maintenance, electrical and instrumentation maintenance, tank inspection, repair and maintenance, industrial cleaning, and American Society of Mechanical Engineers (ASME) code repairs.

Significant fluctuations in revenues, gross profits and operating results are discussed below on a consolidated basis and for each segment. Revenues fluctuate from quarter to quarter due to many factors, including the changing product mix and project schedules, which are dependent on the level and timing of customer releases of new business.

Three Months Ended August 31, 2006 Compared to Three Months Ended August 31, 2005

Consolidated

Consolidated revenues were \$126.9 million in fiscal 2007, an increase of \$17.9 million, or 16.4%, from consolidated revenues of \$109.0 million for fiscal 2006. This improvement in consolidated revenues resulted from a \$14.6 million increase in Construction Services revenues combined with an increase of \$3.3 million in Repairs and Maintenance Services revenues.

Consolidated gross profit increased from \$10.2 million in fiscal 2006 to \$13.3 million during fiscal 2007. This improvement of \$3.1 million, or 30.7%, in gross profit was due to the 16.4% increase in revenues combined with improved margins. Consolidated gross margins increased from 9.3% in fiscal 2006 to 10.5% in fiscal 2007 due to higher margin work from both the Construction Services (which increased to 11.0% in the current year versus 10.4% in the first quarter of the prior year) and Repair and Maintenance Services (which increased to 9.7% in the current year versus 8.0% in the first quarter of the prior year) segments. In addition, the larger consolidated revenue base allowed for further absorption of fixed costs.

Consolidated SG&A expenses were \$7.7 million during fiscal 2007 compared to \$7.2 million for fiscal 2006. This increase of \$0.5 million was primarily due to employee related expenses resulting from additional staff hired to take advantage of a strong market and expenses related to FAS 123(R) for the amortization of grant-date fair value of stock options issued to employees and non-employee directors. Partially offsetting this increase was a decline in legal costs, although the Company continues to aggressively pursue the collections on its contract dispute receivables. SG&A expense as a percentage of revenue decreased to 6.1% in fiscal 2007 compared to 6.6% in the prior fiscal year primarily as a result of the 16.4% increase in revenues.

Restructuring charges in fiscal 2006 of \$0.3 million relate primarily to professional fees and employee severance costs associated with the restructuring program that began in the fourth quarter of fiscal 2005 in response to liquidity issues and the Company's financial results. Since the restructuring was essentially complete at May 31, 2006 there were no restructuring charges in fiscal 2007. The details of this program are discussed further in Note 3.

Interest expense decreased to \$0.7 million during fiscal 2007 as compared to \$2.8 million in fiscal 2006. This sharp decline was primarily due to reductions in our outstanding debt. Current year expense is primarily related to the amortization of prepaid interest on the convertible notes.

Other income in fiscal 2006 of \$0.7 million resulted from gains on the sale of assets identified during the restructuring effort. Fiscal 2007 amounts related primarily to gains from miscellaneous asset dispositions.

Income before income tax expense increased to \$5.0 million in fiscal 2007 from \$0.6 million in fiscal 2006. This \$4.4 million improvement was due to higher gross profit combined with less interest expense, partially offset by higher SG&A expense in fiscal 2007 and larger gains on the sale of assets in fiscal 2006.

The effective tax rates for fiscal 2007 and fiscal 2006 were 40.0% and 38.9%, respectively. The increase in the fiscal 2007 rate was attributable to more income being generated from states with higher tax rates.

Net income for fiscal 2007 improved to \$3.0 million, or \$0.12 per fully diluted share, versus net income in fiscal 2006 of \$0.4 million, or \$0.02 per fully diluted share.

Construction Services

Construction Services' revenues during fiscal 2007 were \$76.8 million, compared to \$62.2 million in the prior fiscal year, an increase of \$14.6 million, or 23.5%. This improvement occurred due to revenue increases from Other Industries of \$9.3 million, the Downstream Petroleum Industry of \$4.0 million and the Power Industry of \$1.3 million. This improvement in Other Industries was primarily related to liquefied natural gas work.

[Table of Contents](#)

Gross profit increased from \$6.4 million in fiscal 2006 to \$8.4 million during fiscal 2007, an increase of 31.1%. The increase was driven by higher revenues and improved margins. Construction Services gross margins grew from 10.4% in fiscal 2006 to 11.0% during fiscal 2007. This improvement occurred due to the inclusion of higher margin downstream petroleum work.

Operating income and income before income tax expense increased to \$4.3 million and \$3.7 million in fiscal 2007 from \$2.6 million and \$1.1 million in fiscal 2006. This improvement was directly related to the benefit of additional revenues and higher gross margins combined with lower interest expense.

Repair and Maintenance Services

Revenues from Repair and Maintenance Services increased \$3.3 million, or 7.0%, from \$46.8 million during fiscal 2006 to \$50.1 million in fiscal 2007. This improvement resulted from increased revenues from the Downstream Petroleum Industry, which grew \$5.1 million. Partially offsetting this improvement were declines in the Power Industry of \$1.6 million and Other Industries of \$0.2 million.

Gross margins of 9.7% for fiscal 2007 were higher than gross margins of 8.0% in fiscal 2006 due to the inclusion of higher margin downstream petroleum projects. Gross profit also improved from \$3.7 million in fiscal 2006 to \$4.9 million in fiscal 2007 due to the 7.0% increase in revenues combined with improved margins on downstream petroleum projects.

Operating income and income before income tax expense were both \$1.3 million for fiscal 2007, which was higher than the operating income and loss before income tax expense of \$0.2 million and \$0.3 million, respectively, produced in fiscal 2006. This improvement was primarily due to higher revenues and improved margins combined with reduced interest expense.

Backlog

Backlog includes the remaining revenue to be recognized on contracts that we consider firm. Contracts with lump sum or cost plus pricing terms are normally included in backlog. As the contract value of time and material contracts is not firm, those contracts are normally excluded from backlog unless the contract includes a minimum contract value. Other than one significant project to construct liquefied natural gas tanks, we expect virtually all of the projects comprising our backlog to be completed within twelve months. Because many of our contracts are performed within short time periods after receipt of an order and as backlog amounts exclude signed time and materials contracts, we do not believe that our level of backlog at the end of any given period is a precise indicator of our future revenues, especially for our Repair and Maintenance Services segment.

The following provides a rollforward of our backlog from May 31, 2006 to August 31, 2006:

	<u>Construction Services</u>	<u>Repair and Maintenance Services</u>	<u>Total</u>
		(In thousands)	
Backlog as of May 31, 2006	\$ 230,117	\$ 18,331	\$248,448
New backlog awarded	120,607	24,444	145,051
Revenue recognized on contracts in backlog	(69,502)	(15,722)	(85,224)
Backlog sold in asset sales or canceled	(644)	(418)	(1,062)
Backlog as of August 31, 2006	<u>\$ 280,578</u>	<u>\$ 26,635</u>	<u>\$307,213</u>

At August 31, 2006, the Construction Services segment had an estimated backlog of work under contracts of approximately \$280.6 million, as compared to an estimated backlog of approximately \$230.1 million at May 31, 2006. The increase was primarily the result of additional work awarded for downstream petroleum services. The total additions to backlog for the Construction Services segment were approximately \$120.6 million in the first three months of fiscal 2007.

[Table of Contents](#)

The backlog at August 31, 2006 for the Repair and Maintenance Services segment was approximately \$26.6 million, an increase of approximately \$8.3 million from May 31, 2006 that was primarily the result of additional work awarded for downstream petroleum services. The total additions to backlog for the Repair and Maintenance Services segment were approximately \$24.4 million in the first three months of fiscal 2007.

The following reconciles revenue recognized on contracts in backlog to total revenue for the first three months of fiscal 2007:

	<u>Construction Services</u>		<u>Repair & Maintenance Services</u>		<u>Total</u>	
	(In thousands, except percentages)					
Revenue recognized on contracts in backlog	\$69,502	90.5%	\$ 15,722	31.4%	\$ 85,224	67.2%
Revenue recognized on contracts not in backlog	7,307	9.5%	34,328	68.6%	41,635	32.8%
Total revenue recognized	<u>\$76,809</u>	<u>100.0%</u>	<u>\$ 50,050</u>	<u>100.0%</u>	<u>\$ 126,859</u>	<u>100.0%</u>

Non-GAAP Financial Measure

EBITDA is a supplemental, non-GAAP financial measure. EBITDA is defined as earnings before interest expense, income taxes, depreciation and amortization. We have presented EBITDA because it is used by the financial community as a method of measuring our performance and of evaluating the market value of companies considered to be in similar businesses. We believe that the line item on our consolidated statements of operations entitled "net income" is the most directly comparable GAAP measure to EBITDA. Since EBITDA is not a measure of performance calculated in accordance with GAAP, it should not be considered in isolation of, or as a substitute for, net earnings as an indicator of operating performance. EBITDA, as we calculate it, may not be comparable to similarly titled measures employed by other companies. In addition, this measure does not necessarily represent funds available for discretionary use, and is not necessarily a measure of our ability to fund our cash needs. As EBITDA excludes certain financial information compared with net income, the most directly comparable GAAP financial measure, users of this financial information should consider the type of events and transactions, that are excluded. Our non-GAAP performance measure, EBITDA, has certain material limitations as follows:

- It does not include interest expense. Because we have borrowed money to finance our operations, interest expense is a necessary and ongoing part of our costs and has assisted us in generating revenue. Therefore, any measure that excludes interest expense has material limitations.
- It does not include income taxes. Because the payment of income taxes is a necessary and ongoing part of our operations, any measure that excludes income taxes has material limitations.
- It does not include depreciation and amortization expense. Because we use capital assets, depreciation and amortization expense is a necessary element of our costs and ability to generate revenue. Therefore, any measure that excludes depreciation and amortization expense has material limitations.

[Table of Contents](#)

EBITDA for the three-month period ended August 31, 2006 was \$7.2 million, compared to EBITDA of \$4.8 million for the three-month period ended August 31, 2005. A reconciliation of EBITDA to net income follows:

	Three Months Ended	
	August 31, 2006	August 31, 2005
	(In thousands)	
Net income	\$ 3,008	\$ 375
Interest expense, net	717	2,770
Provision for income taxes	2,002	239
Depreciation and amortization	1,458	1,447
EBITDA	<u>\$ 7,185</u>	<u>\$ 4,831</u>

The \$2.4 million increase in EBITDA for the three months ended August 31, 2006 as compared to the outstanding three-month period for the prior year was primarily due to improved operating results in both our Construction Services and Repair and Maintenance Services segments.

Financial Condition & Liquidity

Historically, Matrix Service has financed its operations with cash from operations and from advances under its revolving credit facility and recently from convertible debt and the private placement of common stock. Cash and cash equivalents totaled approximately \$4.4 million at August 31, 2006 and approximately \$8.6 million at May 31, 2006. In the three months ended August 31, 2006, operations used \$1.1 million of cash and investing activities used \$3.2 million of cash, while financing activities provided \$0.1 million of cash.

Accounts receivable decreased \$8.0 million, or 12.5%, when comparing the balance of \$56.1 million at August 31, 2006 to the balance of \$64.1 million at May 31, 2006. This decline is consistent with a decrease in revenues which dropped \$10.6 million when comparing the last two months of the quarter ended May 31, 2006 to the last two months of the quarter ended August 31, 2006.

Costs and estimated earnings in excess of billings on uncompleted contracts increased from \$24.5 million at May 31, 2006 to \$34.6 million at August 31, 2006. The \$10.1 million increase is a result of the presence of several large construction projects incurring cost in August that are billed based on reaching milestones or in some cases, billed once per month. Although this is a substantial increase, Matrix Service's net cost in excess of billings only increased \$4.2 million as billings in excess of costs have risen \$5.9 million.

Accounts payable were \$40.9 million as of August 31, 2006, as compared to \$47.1 million as of May 31, 2006. The decline in the payables balance of \$6.2 million, or 13.1%, is due to revenues declining \$10.6 million when comparing the last two months of the quarter ended May 31, 2006 to the last two months of the quarter ended August 31, 2006.

Billings on uncompleted contracts in excess of costs and estimated earnings increased from \$12.1 million at May 31, 2006 to \$18.0 million at August 31, 2006. The \$5.9 million increase was the result of increased billings at the start of certain projects as allowed under the terms of our contracts, primarily in the Construction Services segment.

Other accrued expenses were \$9.5 million as of August 31, 2006, which represents a decrease of \$2.9 million from the \$12.4 million balance as of May 31, 2006. This decrease was primarily due to the payment in fiscal 2007 of incentives earned in fiscal 2006, partially offset by the accrual for incentives earned in the first three months of fiscal 2007.

[Table of Contents](#)

Debt consisted of the following:

	August 31, 2006	May 31, 2006
	(In thousands)	
Debt outstanding:		
Senior credit facility - revolver	\$ —	\$ —
Convertible notes	15,000	25,000
Total debt	<u>\$ 15,000</u>	<u>\$ 25,000</u>

Senior Credit Facility

The Company's Amended and Restated Credit Agreement (Credit Agreement) provides for a \$40 million revolving credit facility. The revolving credit facility may be used for working capital, issuance of letters of credit or other lawful corporate purposes. Availability under the revolving facility is governed by a borrowing base equal to 80% of outstanding accounts receivable less certain exclusions as defined in the Credit Agreement and is further reduced by outstanding letters of credit. On August 31, 2006, availability under the revolving credit facility was \$23.4 million, which represents amounts available under the borrowing base of \$34.5 million less outstanding letters of credit of \$11.1 million. The terms and conditions of the Credit Agreement include customary affirmative and negative covenants, with which the Company was in compliance at August 31, 2006.

At the Company's option, amounts borrowed under the revolving credit facility will bear interest at LIBOR or an alternate base rate, plus in each case an additional margin based on the Senior Leverage Ratio. The alternate base rate is the greater of the prime rate or the fed funds effective rate plus 0.5%. The additional margin ranges from 0.75% to 2.00% on alternate base rate borrowings and from 2.25% to 3.50% on LIBOR-based borrowings. Based upon the terms of the Credit Agreement, the Company may currently borrow in the lowest interest rate tier, resulting in LIBOR and alternative base rate margins of 2.25% and 0.75%, respectively.

The Credit Agreement contains certain provisions that limit the Company's ability to incur additional indebtedness and impose restrictions on capital expenditures. These provisions limit outstanding capital and operating lease obligations to \$12.5 million at any time with a maximum of \$3.5 million in operating lease payments in any fiscal year. Additional restrictions include a limit on capital expenditures of \$12.5 million per fiscal year and a limit on other unsecured indebtedness of \$1.5 million.

The Credit Agreement is guaranteed by all of our subsidiaries and is secured by a lien on substantially all of our assets.

Convertible Debt

In connection with the private placement of \$30 million of five-year convertible notes, on April 22, 2005, we entered into a registration rights agreement with the investors in the convertible notes. The registration rights agreement requires us to use our best efforts to keep our registration statement, covering the resale of the shares of our common stock issuable upon conversion of the convertible notes, continuously effective until the earlier of (a) the date on which all of our common stock covered by such registration statement has been sold or may be sold without volume restrictions pursuant to Rule 144(k) under the Securities Act of 1933, as amended, or (b) the fifth anniversary of the closing date. If we fail to satisfy our obligations under the registration rights agreement, we will owe the holders of the convertible notes as partial liquidated damages an amount in cash equal to 1% of the aggregate amount paid for the convertible notes for each such event, and thereafter on each monthly anniversary of each such event (if the applicable failure shall not have been cured by such date) until the applicable failure is cured, we will owe the note holders an amount in cash equal to an additional 1% of the aggregate amount paid for the convertible notes.

Table of Contents

The convertible notes were issued under a securities purchase agreement among the Company and certain investors, and bear interest at a rate of 7% per year. Beginning on June 30, 2007, the convertible notes will bear interest at a rate of 5% per year if certain conditions defined in the registration rights agreement are met. The notes are convertible into shares of the Company's common stock at an initial conversion price of \$4.69 per share, subject to adjustment for stock dividends, stock splits or other matters as provided for in the securities purchase agreement. An initial interest pre-payment of \$4.2 million was made on April 25, 2005 for the period to and including April 25, 2007. Prepaid interest of \$0.7 million is included in prepaid assets at August 31, 2006. Interest is payable in arrears on each March 31, June 30, September 30 and December 31, beginning on June 30, 2007, through the date of maturity.

The securities purchase agreement requires us to maintain certain financial ratios. It also limits the amount of senior obligations permitted under the senior credit facility or the refinancing or replacement thereof, including new and replacement letters of credit, to \$90 million; limits capital lease obligations to \$12.5 million, limits operating leases to \$15 million, limits purchase money financing to \$1 million and limits debt under the Company's performance and bonding line to \$150 million. The Company is currently in compliance with all terms and covenants of the securities purchase agreement.

In fiscal 2006, \$5.0 million of the convertible notes were converted by note holders into 1,002,275 shares of the Company's Common Stock and on August 3, 2006, an additional \$10.0 million of the convertible notes were converted into 2,091,539 shares. As of August 31, 2006, \$15.0 million of the convertible notes remained outstanding.

Acquisition Payable

As part of an acquisition in fiscal 2003, the Company entered into an acquisition payable for a portion of the purchase price. The acquisition payable is recorded at \$4.4 million at August 31, 2006 and is accreted for the change in its present value each period utilizing a 5.1% effective interest rate. Payments related to the acquisition payable are due annually on March 7, with \$1.9 million due in 2007 and \$2.8 million due in 2008.

Capital Expenditures

Cash capital expenditures during the three months ended in August 31, 2006 totaled approximately \$3.3 million. In addition, the Company routinely acquires assets utilizing capital leases. Assets acquired under capital leases totaled \$0.1 million in the three months ended August 31, 2006 and are not included in the cash capital expenditure number above. The Company now expects capital expenditures for fiscal 2007 to exceed the original budgeted amount of \$9.0 million. This is due to capital required to support future growth as well as cash required for the expected purchase of a regional operating facility, which we are currently leasing.

Even with the anticipated increase in capital spending, the Company believes that cash on hand, cash from future operations and borrowing capacity under the senior credit facility will be sufficient to support operations and future capital requirements.

Outlook

We are extremely pleased with our continued success in executing work with our core customer base and look forward to new opportunities in expanding markets. Our project mix continues to be heavily weighted to the Downstream Petroleum Industry which represented approximately 81% of our first quarter revenues and accounts for more than 72% of our record \$307.2 million in backlog.

Due to the continued strength in the Downstream Petroleum Industry which continues to fuel our earnings growth with additional planned expansions to terminal facilities like the Plains All American Pipeline, L.P. expansion announced in our September 19, 2006 press release, we see strong and growing backlog into the future. We are raising our revenue guidance for the full fiscal year to \$510 million to \$540 million from the \$480 million to \$520 million previously disclosed and continue to expect consolidated gross profit margins of 10.5% to 11.0%.

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical facts, included in this Form 10-Q which address activities, events or developments which we expect, believe or anticipate will or may occur in the future are forward-looking statements. The words “believes,” “intends,” “expects,” “anticipates,” “projects,” “estimates,” “predicts” and similar expressions are also intended to identify forward-looking statements.

These forward-looking statements may include, among others, such things as:

- amounts and nature of future revenues from our Construction Services segment and Repair and Maintenance Services segment;
- our ability to generate sufficient cash from operations, borrow under our Credit Agreement or raise cash in order to meet our short- and long-term capital requirements;
- our ability to continue to comply with the financial covenants in our credit agreement;
- the adequacy of our reserves for contingencies, disputed contracts and insurance losses;
- the likely impact of new or existing regulations on the demand for our services; and
- expansion and other development trends of the industries we serve.

These statements are based on certain assumptions and analyses we made in light of our experience and our perception of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate in the circumstances. However, whether actual results and developments will conform with our expectations and predictions is subject to a number of risks and uncertainties which could cause actual results to differ materially from our expectations, including:

- the risk factors discussed in our Form 10-K for the fiscal year ended May 31, 2006 and listed from time to time in our filings with the Securities and Exchange Commission;
- general economic, market or business conditions;
- changes in laws or regulations; and
- other factors, most of which are beyond our control.

Consequently, all of the forward-looking statements made in this Form 10-Q are qualified by these cautionary statements and there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to or effects on us or our business or operations. We assume no obligation to update publicly any such forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in market risk faced by us from those reported in our Annual Report on Form 10-K for the fiscal year ended May 31, 2006, filed with the Securities and Exchange Commission. For more information on market risk, see Part II, Item 7A in our 2006 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of August 31, 2006. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting during the quarter ended August 31, 2006.

PART II**OTHER INFORMATION****ITEM 1. Legal Proceedings**

For information regarding legal proceedings, see Notes 9 and 10 in Item 1 of Part 1 of this Quarterly Report on Form 10-Q, which information is incorporated by reference into this Part II, Item 1.

ITEM 1A. Risk Factors

There were no material changes in our Risk Factors from those reported in Item IA. of Part I of our Annual Report on Form 10-K for the fiscal year ended May 31, 2006.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**Issuer Purchases of Equity Securities**

In October 2000, the Board of Directors authorized a stock buyback program, which permitted the purchase of up to 20% (i.e., 3,447,506 shares) of the common stock outstanding at that time. To date, Matrix Service has purchased 2,116,800 shares under the program and has authorization to purchase an additional 1,330,706 shares.

The Company intends to utilize these purchased treasury shares solely for the satisfaction of stock issuance under the 1990, 1991 and 2004 Stock Option Plans and the 1995 Nonemployee Directors Stock Option Plan:

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Shares That May Yet Be Purchased Under the Plans or Programs
June 1 - 30, 2006	—	\$ —	2,116,800	1,330,706
July 1 - 31, 2006	—	\$ —	2,116,800	1,330,706
August 1 - 31, 2006	—	\$ —	2,116,800	1,330,706
Total	<u>—</u>	<u>\$ —</u>	2,116,800	1,330,706

Dividend Policy

We have never paid cash dividends on our Common Stock. We currently intend to retain earnings to finance the growth and development of our business and do not anticipate paying cash dividends in the foreseeable future. Any payment of cash dividends in the future will depend upon our financial condition, capital requirements and earnings as well as other factors the Board of Directors may deem relevant. Our credit agreement limits the amount of cash dividends we can pay.

ITEM 3. Defaults Upon Senior Securities

Not applicable

ITEM 4. Submission of Matters to a Vote of Security Holders

Not applicable

ITEM 5. Other Information

Not applicable

[Table of Contents](#)

ITEM 6. Exhibits:

- Exhibit 31.1: Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 – CEO.
- Exhibit 31.2: Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 – CFO.
- Exhibit 32.1: Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) – CEO.
- Exhibit 32.2: Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) – CFO.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MATRIX SERVICE COMPANY



Date: October 5, 2006

By: /s/ George L. Austin

George L. Austin Vice President-Finance and Chief Financial Officer signing on behalf of the registrant and as the registrant's chief accounting officer.

EXHIBIT INDEX

- Exhibit 31.1: Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 – CEO.
- Exhibit 31.2: Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 – CFO.
- Exhibit 32.1: Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) – CEO.
- Exhibit 32.2: Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) – CFO.

CERTIFICATIONS

I, Michael J. Hall, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Matrix Service Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 5, 2006



Michael J. Hall
President and Chief Executive Officer

CERTIFICATIONS

I, George L. Austin, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Matrix Service Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 5, 2006



George L. Austin
Vice President – Finance
and Chief Financial Officer

Certification Pursuant to 18 U.S.C. Section 1350,
As Adopted Pursuant
Section 906 of Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Matrix Service Company (the "Company") on Form 10-Q for the period ending August 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael J. Hall, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 5, 2006

A handwritten signature in black ink, appearing to read "m/j Hall". The signature is written in a cursive, somewhat stylized font.

Michael J. Hall
President and Chief Executive Officer

Certification Pursuant to 18 U.S.C. Section 1350,
As Adopted Pursuant
Section 906 of Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Matrix Service Company (the "Company") on Form 10-Q for the period ending August 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, George L. Austin, Vice President, Finance and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 5, 2006

A handwritten signature in black ink, appearing to read "George L. Austin". The signature is fluid and cursive, with a large loop at the end.

George L. Austin
Vice President – Finance
and Chief Financial Officer