INDUSTRIAL DISTRIBUTION GROUP INC
Form 10-K
March 11, 2005

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended December 31, 2004

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

For the Transition Period from ________ to ________

Commission File No. 001-13195

INDUSTRIAL DISTRIBUTION GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	58-2299339 (I.R.S. Employer Identification No.)

950 East Paces Ferry Road, Suite 1575, Atlanta, Georgia 30326
(Address of principal executive offices) (Zip Code)

Registrant s Telephone Number, Including Area Code: (404) 949-2100

Securities Registered Pursuant to Section 12(B) of The Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, Par Value $0.01 Per Share	NASDAQ

Securities Registered Pursuant to Section 12(G) of the Act:

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes o No þ

The aggregate market value of the voting stock held by non-affiliates (which for purposes hereof are all holders other than executive officers and directors) of the Registrant as of June 30, 2004 was $67,643,290 (based on 8,149,794 shares held by non-affiliates at $8.30 per share, the last sales price on the NASDAQ on June 30, 2004).

The number of shares outstanding of the registrant s common stock as of February 25, 2005 was 9,399,500.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement for the 2005 Annual Meeting of Stockholders, to be filed with the Commission, are incorporated by reference into Part III.

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PART I

Item 1. *Business*.

Background and General

Industrial Distribution Group, Inc. (IDG) was formed in 1997 through a combination of industrial distribution companies. We are a nationwide supplier of maintenance, repair, operating, and production (MROP) products and services to manufacturers and other industrial users, with a principal focus on providing an array of value-added business process outsourcing services and other arrangements through our Flexible Procurement Solutions (FPS) model. Our FPS services include storeroom management (commonly referred to as integrated supply) and other offerings that emphasize and utilize our specialized expertise in product applications and production process improvements. In providing FPS services and traditional direct sales of MROP products, which we refer to as General MROP sales, we distribute a full line of MROP products, specializing in cutting tools, abrasives, hand and power tools, coolants, lubricants, adhesives, safety products, and machine tools. We can supply at a competitive price virtually any other MROP product that a customer may require.

Our FPS customers, which account for approximately 55% of our business, range from mid-market (i.e., greater than $50,000 but less than $500,000 in potential annual revenues) to large market (i.e., greater than $500,000 in potential annual revenues) accounts which remains our focus for continuous growth. We believe as we widen our FPS services and product selection, we will continue to position IDG to address proactively the increasing demands of customers for ways to reduce their overall MROP costs and enhance their operating efficiencies. In many of our FPS arrangements, we seek to answer these demands by guaranteeing a minimum annual reduction in our customer s total MROP procurement costs through our Documented Cost Savings Program. We are able to guarantee these cost reductions by leveraging our expertise and our ability to analyze a customer s acquisition, possession, and application processes for MROP products to design and implement a customized program and streamline these processes in order to reduce their associated costs. The specific programs we design may include improving the customer s production and procurement processes, standardizing the products they use, reducing the number of suppliers from which they purchase products, or developing storeroom management arrangements that outsource to us some or all of their MROP procurement and management functions. Our General MROP customers tend to be small to mid-market customers whose purchase levels are not large enough to warrant a services-based solution but that still have a need to benefit from our procurement and product application expertise.

Our operations are organized into four regional divisions. Each regional division is headed by a President who reports directly to our Chief Executive Officer. We currently have sales coverage in 43 of the top 75 manufacturing markets in the United States as well as Mexico and China. We have approximately 20,000 active customers (customers that purchased at least one item in the last 12 months), which include a diverse group of large and mid-sized national and international corporations, including General Electric Company, The Boeing Company, Arvin Meritor, Borg-Warner Inc., and Pentair, Inc. as well as many local and regional businesses.

We had net sales of $529.2 million for the year ended December 31, 2004. Based on 2004 sales, we believe IDG is among the top 16 MROP providers and the top five operators of storeroom management sites in the nation.

Industry Overview and Trends

Manufacturers, processors, and other producers of industrial, commercial, or consumer products have a continual need for a broad range of MROP products. We estimate that the size of the market for industrial MROP products in which we primarily participate is approximately $70 billion annually. However, the entire U.S. MROP market is estimated to be in excess of $175 billion annually. This broader market includes electrical, PVF (pipes, valves, and fittings), power transmission, and other product categories in which we participate to a lesser extent than the industrial MROP product market.

Manufacturers and other users of MROP products continue to seek ways to enhance efficiencies and reduce MROP process and procurement costs in order to compete more effectively in the global economy. As a result, the

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industrial supply industry continues to experience consolidation, as customers focus on the convenience, cost savings, and economies of scale associated with a reduced number of suppliers who are capable of providing superior service and product selection.

In recent years, technological advancements have enhanced the business-to-business solutions provided by the MROP industry. Business-to-business solutions are needed in today s marketplace to provide customers with the option to outsource the commodity management aspects of MROP. As manufacturers have focused on their core manufacturing or other production competencies, they have increasingly outsourced their MROP procurement, management, and application processes in search of more comprehensive MROP solutions that include technology solutions that we provide. We have moved with the trend of the industry by using technological advancements and the development of Internet-based platforms to create procurement solution strategies.

We believe that we have the size, scale of operations, technology, and skilled personnel resources necessary to benefit from these industry trends and compete effectively in the MROP supply industry.

Flexible Procurement Solutions (FPS)

Services Program and Approach

FPS is a broad program of value-added service offerings to our customers and reflects our principal approach to addressing the MROP needs of our customers. We approach our customers and their needs proactively, not simply to sell MROP products, but to help design an overall MROP strategy that improves our customers supply chain and asset management and increases their operational efficiencies. We offer our customers our expertise in process improvement, inventory management, product application, productivity improvements, cost savings, software solutions, and logistics. Through FPS, we can provide any or all of these areas of expertise, depending on the size and the specific needs of the customer. As a result of our services, we believe that our customers can increase their profits and their return on assets.

We believe that the ability and flexibility to provide the ideal combination of MROP services required by each customer is the key to capturing market share for our business. The prerequisites for doing so will continue to evolve, and we will remain vigilant in assessing the needs of and developing solutions for our existing and prospective new customers. At December 31, 2004, we had arrangements in place to provide FPS services to approximately 262 customers covering 341 sites, including 97 storeroom management sites covering 58 customers.

Spectrum of Service Offerings

The spectrum of services we offer in designing and implementing Flexible Procurement Solutions for customers is broad and encompasses all phases of a customer s MROP cycle that is, the acquisition, possession, and application of MROP products. Our extensive process knowledge and the product expertise of our associates are key elements that allow us to present cost saving solutions to our customers in all of these phases. For example, our comprehensive product line supports our commitment to acquire and deliver the most appropriate product to our customers. In addition to maintaining more than 300,000 stock-keeping units (SKUs), as well as special items in stock for regular customers, we can provide virtually any MROP item a customer may require. Our proprietary software programs provide a sophisticated system for our customers to accurately track their possession and use of these products. Moreover, our industry-specific experience and extensive product knowledge enable us to assist in the application of MROP products by evaluating manufacturing processes and the MROP products they use. Our understanding of the most appropriate product for specific customer applications helps us to identify the MROP product best suited for a customer s specific need, or we may suggest process re-engineering in order to lower the customer s total MROP costs.

The proper management of the acquisition, possession and application functions is important to customers because they must balance the need for immediate access to inventory with the cost of carrying the inventory. Many MROP products such as machine tool inserts, drill bits, abrasives, saw blades, and gloves are consumed in production processes and are essential to maintain at the point of production to avoid unnecessary downtime. Other MROP products such as power tools, scales, hoists, and lathes have relatively longer operational lives and are

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therefore purchased less frequently, but still must be available on time in order to achieve production efficiencies. In all cases, the management of all phases of our customers MROP cycle is a fundamental part of our FPS services for our customers.

In addition to identifying and supplying the particular products a customer requires (in the proper quantities and at the proper times), our specialized services may include any one or more of the following to assist the customer in the acquisition, possession and application phases of the MROP cycle:

- providing consolidated billing for MROP products and producing computerized management reports to customers regarding purchases and inventory levels;

- installing computer software and hardware to implement an electronic data interchange system to enable the customer to order products electronically, without contacting us, by telephone or facsimile;

- providing storeroom design and reorganization services to reduce inefficiencies, redundancies, obsolescence, and shrinkage;

- bar coding products in a customer s tool crib to control inventory and track consumption by product, employee, and/or cost center; and

- providing the management and procurement of entire commodity groups utilizing our proprietary software to enable commodity rationalization, supplier surveys, supplier requests for quotes, quotation analysis, supplier selection, and contract awards.

Storeroom Management Arrangements

Our business process outsourcing model is the most complete offering of services in our FPS program. This model is considered a storeroom management relationship (commonly referred to in our industry as integrated supply), where we essentially form a strategic alliance with the customer to procure, manage, and apply MROP products at the customer s site and, in some cases, to share the benefits of the cost reductions achieved. In addition to all or most of the other FPS services we provide, our storeroom management relationships which are not standardized and vary from customer to customer usually include:

- licensing to the customer our proprietary software that helps provide our customers with business intelligence to manage the acquisition, receipt, issuance, and application of MROP products and other key commodity supplies;

- gaining access to plant floors to re-engineer procurement and production processes and standardize MROP products;

- coordinating the purchase of multiple MROP product lines;

- providing consolidated invoices and customized management reports via a direct network link to customers; and

- managing and staffing tool cribs.

In addition, in a storeroom management relationship, we, rather than the customer, may own the inventory in the tool crib.

In such a relationship, we often achieve a minimum annual reduction in the customer s total MROP costs in relation to its production levels. We achieve these cost reductions through our focused and ongoing analysis and re-engineering of a customer s production processes to reduce the variety and number of MROP products that the customer uses. In addition, we often achieve additional cost savings and improved cash flows for our customer

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through the reduction of tool crib staffing expenses, the reduction in shrinkage and obsolete stock due to better inventory controls, and the elimination of certain inventory holding costs.

We show our customers how we achieve savings for them through our Documented Cost Savings Program. Our customers agree with us on the savings criteria and measurements at the beginning of the relationship. Our service performance is measured to these pre-determined expectations. Where we save additional costs for a customer through these process improvements, and exceed their expectations in certain arrangements, the customer may share the additional savings with us.

We believe that, for appropriate customers, a storeroom management arrangement also has other benefits. For example, through the use of our proprietary Storeroom Management System, key products are readily available to our customers, which reduces their production downtime. We can also provide more useful information than our customers had previously collected about their inventory needs and consumption by cost center.

Quality Control Standards

Providing superior quality throughout the comprehensive range of MROP services we provide to customers is our hallmark. As part of our commitment to providing solutions-oriented customer service, we emphasize quality assurance in all phases of our operations. Our sales and service personnel receive ongoing periodic training in our services solutions, our products, total quality management and other team management skills to assure quality performance. As a result, all of our significant operating locations are ISO 9001 compliant.

Products

In tandem with our FPS program and its approach to serving our customers, we remain focused on satisfying the fundamental requirement of our distribution business getting customers the MROP products they need, when they need them. In order to do so, we offer a full line of industrial MROP products, with more than 300,000 SKUs in stock. In addition, we often maintain supplies of special items for regular customers, and we are able to supply virtually any special order MROP item at a competitive price. In order to achieve cost savings for us and for our customers, we periodically review our special order activities to identify items ordered with sufficient frequency to warrant inclusion in our stock.

Our principal product categories include cutting tools, abrasives, hand and power tools, maintenance equipment, coolants, lubricants, adhesives, machine tools and safety products. We are able to offer significant depth and breadth in our core product lines throughout our nationwide operations. Our offering of specific products from multiple manufacturers, at different prices and quality levels, permits us to offer the product that provides the best value for the customer. For example, if a customer requires a drill bit to drill 100 holes, purchasing a top-of-the line product that is designed for a requirement of drilling 10,000 holes would be inefficient and costly. Our associates are trained specifically to assist customers in making such intelligent cost-saving purchases, with the goal of lowering the customer s total MROP procurement costs. We believe these factors significantly enhance our volume of repeat business, and they are an integral part of our overall customer costs reduction program and total procurement solutions.

On an individual location basis, our products may be ordered electronically through business interchange services, e-commerce, by telephone, or by facsimile. We seek at all times to provide our customers with the most convenient method of selecting and ordering products, which in the future may include paper and electronic catalogs, internet and other electronic commerce. To facilitate on time delivery of our products, we store our stock MROP products primarily in distribution centers and smaller warehouses at various locations across the United States and Shanghai, China.

We currently obtain products from approximately 35,000 vendors. During 2004, no vendor provided as much as 7% of the products we sold. We believe we are not materially dependent on any one vendor or small group of vendors.

The following table sets forth illustrative examples of the myriad products we supply, organized by principal categories of MROP products, and also shows our sales of such products as a percentage of our aggregate revenue for 2004:

Product Category	**Typical Products**	**% of Aggregate Revenue**
Cutting Tools	Drills, Taps, Carbide Tools, End Mills	22.5%
Abrasives	Grinding Wheels, Sanding Belts, Discs, Sheets or Rolls	11.0%
Power Tools	Air and Electric Drills, Air Compressors, Impact Wrenches, Screwdrivers	8.4%
Maintenance Equipment and Supplies	Hydraulic Tools, Paint, Lubrication Equipment	7.9%
Hand Tools	Wrenches, Socket Sets, Screw Drivers, Hammers	7.6%
Coolants, Lubricants, and Adhesives	Metal Cutting Coolants, Aerosols, Industrial Adhesives	6.6%
Machine Tools and Accessories	Milling Machines, Work Holding Vises, Tool Holders	5.2%
Safety Products	Gloves, Signs, Absorbents, Glasses	5.1%
Tapes	Masking, Filament and Duct Tape	4.2%
Material Handling Equipment	Hoists, Slings, Chain, Shelving, Casters	2.8%
Machinery	Metal Removal Equipment, Metal Forming Equipment	2.1%
Fluid Power	Hydraulic and Pneumatic Values, Cylinders	1.6%
Saw Blades	Band, Hack, Hole, Jig Saw Blades	1.6%
Contractor Supplies	Power-Actuated Tools, Ladders, Shovels	1.5%
Electrical	Fuses, Electrical Switches, Controls	1.4%
Fasteners	Socket Screws, Hex Screws, Anchors	1.3%
Tool & Die Supplies	Ground Stock, Drill Rod, Die Sets	1.2%
Brushes	Wire Wheel, Floor Brooms	0.9%
Power Transmission Equipment	Belts, Drives, Bearings, Gears, Pulleys	0.9%
Quality Control Products	Electronic Calipers, Micrometers	0.9%
Industrial Hose	Air Hose, Water Hose	0.7%
Industrial Pipes, Valves, Fittings and Metal Goods	Pipes, Valves, Fittings, Angle Iron, Conduit	0.7%
Welding Equipment and Supplies	Welders, Weld Rod	0.6%
OEM Assembly Parts	Gaskets, Springs, Assembly Plates	0.5%
Other Products		2.8%
Total		100.0%

Customers

Our active customers, who number approximately 20,000, include a broad range of industrial, commercial, and institutional users of MROP products, from small local machine shops to regional, national, and multi-national corporations such as General Electric Company, The Boeing Company, Arvin Meritor, Borg-Warner Inc., and Pentair, Inc. For 2004, we sold products to over 1,000 customers who purchased at least $50,000 of products, and no single customer accounted for more than 5% of our net sales.

We will continue to serve a large number and wide variety of customers. Our principal customers (in terms of the amount of services and products acquired from or through us) will likely continue to be divisions of large international, national, and middle-market corporations, and we will focus on increasing our business with such customers. We also place special emphasis, through our FPS program, on marketing and selling our services and products to middle-market industrial consumers. We believe these manufacturers may benefit from many of our value-added service offerings.

Sales and Marketing

Each of our four regional divisions has personnel dedicated to FPS sales and marketing efforts focused on the regional and local markets. We have approximately 180 outside sales representatives and product specialists and 180 inside sales/customer service representatives. The majority of our outside sales representatives and product specialists call on designated customers and are responsible for providing technical support to those customers with respect to certain products. Our outside sales representatives and product specialists play an integral part in our marketing strategy for FPS services by focusing on the broader spectrum of MROP services and then developing and marketing customized value-added solutions to new and existing customers. These solutions go beyond the sale of our products and help to improve our customers production processes and as a result, reduce their total procurement costs. They support our 17 regional FPS sales experts who focus solely on this aspect of our business. Our inside sales/customer service representatives are responsible for certain types of direct customer service and order entry, but primarily focus on supporting the outside sales representatives with respect to their respective customers.

Our Vice President of Flexible Procurement Solutions is responsible for the development of large national accounts that require cross-regional coordination and assisting our regional efforts when necessary. We believe this approach allows us to compete effectively both in local markets and for multi-location contracts.

We continue to assess, train, and augment our sales force as necessary to assure that it has the appropriate sales tools to achieve the objectives of our strategy to focus on FPS. We will also continue to ensure that we have adequate personnel to provide our customers with any dedicated or specialized product selection and applications expertise they require for their MROP solutions.

We provide regular training programs for our sales personnel and special training programs for various product lines on both a national and regional basis. Each region also maintains a technical support group, as part of its overall sales and marketing function, dedicated to answering specific customer inquiries, assisting customers with the operation of products, and finding low cost solutions to manufacturing problems.

Management Information Systems

We continue to work company-wide to improve our back office information technology systems on a cost-effective basis. Currently, we operate on three nationally recognized distribution systems through which we manage key functions on a regional basis, such as communication between warehouse and sales offices, inventory and accounts receivable management, purchasing, pricing, sales and distribution, and the preparation of periodic operating control reports.

At our customer locations, we utilize computerized management and information systems, including our highly specialized distributor based software programs such as our proprietary Storeroom Management System, InnoSource®, and Innoanalysis System for customer product procurement and management. These systems assist us in our business-to-business product offerings, and are important elements of our overall ability to meet customers requirements for increasing levels of individualized MROP procurement solutions, as well as to achieve our desired level of internal operating efficiencies. Our proprietary Storeroom Management System, InnoSource®, and Innoanalysis System are also key components in our FPS program.

In early 2005 we hired our CIO who will lead our IT strategy. We have a comprehensive IT strategy that includes ongoing strategic initiatives, that are focused on centralization, e-commerce capabilities, FPS operations integration and standardized part numbering and descriptions. We have begun an analysis which will culminate in our selection of one integrated IT platform. This one platform will provide IT solutions that will help our customers place and track their orders more easily, which will enable us to more effectively implement our business strategy. This phase includes a plan to implement a centralized data management system which will reduce the number of regional platforms. We expect an implementation in early 2006.

Competition

The industrial MROP products industry is highly competitive and features numerous distribution channels, including: international, national, regional, and local distributors; direct mail suppliers; internet suppliers; large catalog warehouses; and manufacturers own sales forces. Many of our competitors are small enterprises who sell to such customers in a limited geographic area, but we also compete against several large MROP distributors that have significantly greater resources than we do. Certain of our competitors sell identical products for both lower and higher prices than we offer.

We believe, however, that we are able to compete effectively because of our ability to address the MROP needs of our customers by providing value-added services and solutions (as well as MROP products) that enable them to improve productivity and reduce costs.

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Personnel

We had 1,325 full-time associates as of December 31, 2004. Of these, approximately 350 associates reside at our customers storeroom management facilities. Eight of our associates are employed pursuant to collective bargaining agreements with local unions affiliated with the International Brotherhood of Teamsters and the International Brotherhood of Electrical Workers. We believe that the regions that have been employing persons pursuant to those contracts enjoy good relations with these associates, and we have not experienced work stoppages. We believe our business relationships are good with all of our associates.

Executive Officers

Certain information regarding our executive officers is set forth in the following table and paragraphs.

Name	Age	Position
Andrew B. Shearer	41	President and Chief Executive Officer
Jack P. Healey	45	Senior Vice President, Chief Financial Officer, and Secretary
Thomas W. Aldridge, Jr.	57	Senior Vice President
Michael W. Brice	40	Senior Vice President and Chief Information Officer
Martin C. Burkland	53	President (Northwest region)
John R. Kramer	41	President (Midwest region)
Charles A. Lingenfelter	54	President (Southern region)
Robert E. Vanderhoff	49	President (Northeast region)

Mr. Shearer is one of our co-founders, and became our President and Chief Executive Officer in August 2001. Prior to that time, Mr. Shearer served as the President of our IDG-York business unit (from 1991), formerly Shearer Industrial Supply Co., one of the companies that combined to form us in 1997. Mr. Shearer received his undergraduate degree in Business Management from New Hampshire College.

Mr. Healey joined us in June 1997 as Vice President and Chief Financial Officer, and became Senior Vice President in 1997. Prior to 1997, Mr. Healey was the partner in charge of assurance services for a regional accounting firm and member of the SEC practice section of the AICPA, during which time he served as auditor for one of our founding companies. Mr. Healey is a certified public accountant and a certified fraud examiner. He received his undergraduate degree in Accounting from Syracuse University.

Mr. Aldridge joined us in August 1998, as Senior Vice President of Procurement. Prior to that time, Mr. Aldridge served (from 1991) as Senior Vice President, Vendor Relations, of Affiliated Distributors, a purchasing organization for industrial distributors. From 1987 to 1990, Mr. Aldridge served as Vice President Sales of Bauer Corporation, a manufacturer of industrial ladders and personal access equipment. Mr. Aldridge received his undergraduate degree in Psychology from the University of Georgia.

Mr. Brice joined us in January 2005 as Senior Vice President and Chief Information Officer. Prior to that time, Mr. Brice served (from 2001) as Partner of Unisys, a worldwide information technology services and solutions company. From 2000 to 2001, Mr. Brice served as Vice President of Collaborex, a business-to-business consulting company. Prior to that time, Mr. Brice was a Principal at Booz-Allen & Hamilton, a strategy and technology consulting firm. Mr. Brice received his undergraduate degree in Computer Science from Clemson University.

Mr. Burkland was named Regional President of our Northwest region in January 2002. Prior to that time, Mr. Burkland served (from 1995) as President of our IDG-Seattle business unit, formerly B&J Industrial Supply Co., one of the companies that combined to form us in 1997. Mr. Burkland received his undergraduate degree in Biology from Central Washington University.

Mr. Kramer joined us as the Regional President of our Midwest region in November 2002. From 1988 to 2002, Mr. Kramer was employed in several capacities with General Electric Company, most recently as U.S. Business

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Sales Leader for GE Polymershapes. Mr. Kramer received his undergraduate degree in Business Administration and Spanish from St. John s University.

Mr. Lingenfelter was named Regional President of our Southern region in January 2002. Prior to that time, Mr. Lingenfelter served as President of our IDG-Charlotte business unit (from January 2001) and as President of The Distribution Group, Inc. (from 1997), one of the companies that combined to form us in 1997 and with whom he had been an executive since 1988. Prior to 1988, Mr. Lingenfelter was employed in several capacities with Ingersoll-Rand Company, including as Vice President of Sales and Marketing for its Tools Group. Mr. Lingenfelter received his undergraduate degree in Mechanical Engineering from the Indiana Institute of Technology.

Mr. Vanderhoff joined us as Regional President of our Northeast region in February 2004. From 2000 to 2003, Mr. Vanderhoff served in management positions with Coleman Cable, Inc., most recently as Corporate Senior Vice-President. From 1990 to 2000, Mr. Vanderhoff was employed in several capacities with Wesco Distribution including as Vice President of Manufactured Structures. Mr. Vanderhoff received his undergraduate degree in Behavioral Sciences from Messiah College.

Certain Factors Affecting Forward Looking Statements

From time to time, information provided by us or statements made by our directors, officers or employees may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995 and are subject to numerous risks and uncertainties. Any statements made in this Annual Report on Form 10-K, including any statements incorporated by reference, that are not statements of historical fact are forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may , will , should , expects , plans , anticipates , believes , estimates , predicts , intends , potential , continue , or the negative of such terms or othe comparable terminology. Forward-looking statements include our expectations with respect to growth of sales, the effect of economic conditions, the impact of operational improvements or cost reduction initiatives, operating margins and overall profitability.

These forward-looking statements and other forward-looking statements made by us or our representatives are based on a number of assumptions and involve a number of risks and uncertainties, and, accordingly, actual results could differ materially. Factors that may cause such differences include, but are not limited to, the following:

Our industry is very competitive, both as to the number and strength of the different companies with which we compete and the business terms offered to potential customers.

The industrial MROP supplies industry is highly competitive and features numerous distribution channels, including: international, national, regional, and local distributors; direct mail suppliers; internet suppliers; large catalog warehouses; and manufacturers own sales forces. Many of our competitors are small enterprises who sell to customers in a limited geographic area, but we also compete against several large distributors that have significantly greater resources than we do. Competition with all of these distributors has increased as customers increasingly seek low-cost alternatives to traditional methods of purchasing and sources of supply by, among other things, reducing the number of their MROP suppliers.

Competition in the MROP supplies industry may increase in other ways as well. For example, other distributors are consolidating to achieve economies of scale and increase efficiencies, which may strengthen their competitive position relative to us. In addition, new competitors, of which we are not currently aware, may emerge, further increasing competition.

Some of our competitors presently sell some of the same products we sell at lower prices than we offer. Moreover, we compete on the basis of our ability to design and implement Flexible Procurement Solutions that will enable our customers to achieve productivity improvements and reduce costs overall, rather than seeking simply to offer the lowest price for any particular MROP item. While we believe such FPS services are increasingly attractive to more customers, we cannot assure you that we will be able to compete successfully if such low unit-cost suppliers become predominant in our target markets.

Based on our perception of industry trends among MROP customers, we have dedicated significant resources to our FPS program, but we cannot be certain that these initiatives will generate the growth and profitability we anticipate and desire.

We have dedicated significant resources to promote our FPS program as a strategic area for future growth and profitability. In particular, we have redirected our sales and marketing efforts towards sales of broad-based services and products through this program, rather than towards sales of particular products. This focus is based on our perception of industry trends among users of MROP products for more comprehensive solutions to their MROP requirements. If the trends that we perceive do not continue to develop, FPS sales may not grow at the levels we anticipate and desire, and our results of operations could be affected.

We expect that our continued focus on FPS will require a substantial amount of time and effort in the retraining of our sales and marketing personnel. We may encounter unanticipated difficulties in retraining our sales and marketing personnel to focus more broadly on the sale of FPS services to our customers, rather than focusing exclusively or primarily on direct sales of MROP products.

The delivery of our services requires highly skilled and specialized employees who are not easy to locate or replace.

The timely provision of our high-quality services requires an adequate supply of skilled sales and customer service personnel, including the specialists whose expertise is an essential element of both our customer-oriented FPS program and our General MROP business. Accordingly, our ability to implement solutions for our customers depends to a significant degree on our ability to employ and train the skilled personnel necessary to meet our marketing and servicing requirements. From time to time, we have experienced difficulty in attracting or retaining sufficient numbers of qualified personnel. As a result, our operating costs may be adversely affected by turnover in such positions. We cannot be assured that we will be able to maintain an adequately skilled sales and customer service force or that our labor expenses will not increase as a result of a shortage in the supply of such skilled personnel.

We rely heavily on our senior management and the expertise of management personnel.

Our operations will depend for the foreseeable future on the efforts of our executive officers, regional presidents, and our other senior management. Our business and prospects could be adversely affected if these persons, in significant numbers, do not perform their key roles as expected or leave the company, and we are unable to attract and retain qualified replacements.

We continue to rely upon our three regional management information systems for our internal management information and related functions, which could adversely affect our operations until we can implement our centralized data management system.

We utilize and are dependent upon the information and operating systems of our three regional platforms for many functions, including procurement of products, financial reporting and analysis, and inventory control, among others. In addition, our proprietary FPS software programs are not fully integrated with any of our regional platforms. Although we have put control mechanisms in place to avoid delays, disruptions, and unanticipated expenses until we implement, integrate, and operate centralized systems, these problems may occur and could have a material adverse effect on our operations. In addition, we will not be able to achieve the full benefit of certain contemplated operating efficiencies until we have fully implemented our centralized data management information and operating systems and integrated our proprietary FPS software programs into those systems.

Our ability to sell our services and products in the quantity we desire depends heavily upon the operations levels of our customers and the economic factors that affect them.

Some of the primary markets for the products and services we sell are subject to cyclical fluctuations that generally affect demand for industrial and consumer durable goods that the users of MROP supplies produce. Consequently, the demand for our services and products has been and will continue to be influenced by most of the same regional, national, or even international economic factors that affect the demand for and production of such goods. When our customers or prospective customers reduce their production levels in response to lower demand for their products, as happened in the recent economic downturn, they have less need for MROP supplies and may delay or slow (or even cancel) orders for MROP products or services.

Our dependence upon outside suppliers and manufacturers of MROP products makes us subject to price increases and delays in receiving such products due to market demand, material shortages, and other factors.

We generally do not maintain supply agreements with third parties for MROP products, but instead purchase the products we sell pursuant to purchase orders in the ordinary course of business. We are and will continue to be subject to price increases charged by our supply sources and to failures or delays by them in delivering the quantities of products we require. There can be no assurance that we will be able to pass any price increase on to our customers, and a price increase in excess of the amount we can pass on to our customers could adversely affect our profit margin. A failure or delay in our supply of products could adversely affect our sales and our ability to meet our delivery schedules to customers. Although we believe that our existing suppliers will continue to meet our requirements, at prices that are acceptable, and that alternative sources of supply would be available, events beyond our control could have an adverse effect on the cost or availability of the products we sell.

Because some of our customers are increasingly moving portions of their operations overseas in order to reduce manufacturing costs, we are increasingly exposed to risks such as foreign currency fluctuations, different business cultures, and international laws and regulations, and we cannot guarantee that we will retain customers that relocate their operations overseas.

During fiscal 2004, we derived less than 1% of our revenue from international customers, but we expect our volume of international business to increase. Some arrangements with our international customers have payment terms that are denominated in foreign currencies, and thus contain inherent risks such as foreign currency exchange risks and the risk associated with expatriating funds from foreign countries. If our revenue or expenses denominated in foreign currencies increases, our exposure to such risks would also increase.

The different business cultures associated with international operations may not be fully appreciated before we sign an agreement, and thus may expose us to risk. Likewise, international laws and regulations, such as foreign tax and labor laws, need to be understood prior to signing a contract to provide products or services for a customer s international operations. For these reasons, pricing and executing international contracts is more difficult and carries more risk than pricing and executing domestic contracts. It may also be more difficult to collect on international work that has been performed and billed.

We rely on a variety of distribution rights granted by our suppliers to offer their product lines to our customers.

For a substantial portion of our business, we depend on the collection of varied distribution arrangements with suppliers for certain product lines that have been established by our regional divisions in their respective geographic markets. A significant percentage of these current distribution arrangements are oral, and many of them can be terminated by the supplier immediately or upon short notice. The termination or limitation by any key supplier of its relationship with us could have a material adverse effect on our results of operations and financial condition.

Compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 relating to internal controls over financial reporting may identify breakdowns in our internal control procedures, which might prevent or delay our compliance of those requirements when they become applicable to us.

When section 404 of the Sarbanes-Oxley Act of 2002 and related rules become applicable to us, they will require that our management document and test internal controls over financial reporting and assert whether our procedures for such matters are effective. In addition, our independent auditors will be required to report on management s assessment and the effectiveness of our internal controls procedures. We expect to become subject to compliance with those requirements at the end of our December 31, 2005 fiscal year, and we will be required to provide management s assessment and our auditor s report in our annual report for that year and thereafter. Any material weakness in our internal controls over financial reporting that exists at December 31, 2005 would preclude our management and our independent auditors from making a positive assessment and report. We are in the process of documenting and testing our internal controls over financial reporting in order to provide the basis for that assessment and report. At this time, we cannot provide assurance that we will not discover instances of weakness or breakdowns in our internal controls procedures and, if so, that our efforts to remediate any such matter will be successful in time to provide a basis for a positive assessment and report by our management and auditors, respectively.

Item 2. *Description of Facilities*.

Currently, we own five and lease 36 operating properties in the United States for our warehouse, sales, and administrative offices. We also lease two properties in a foreign country. Certain property locations contain multiple operations such as a warehouse and a sales office. The facilities range in size from less than 1,000 square feet to over 120,000 square feet. Leases for the facilities expire at various periods between 2005 and 2020. The aggregate annual lease payments for real properties in 2004 was approximately $6.5 million.

Our corporate offices are located in approximately 9,500 square feet of office space at 950 East Paces Ferry Road, Suite 1575, Atlanta, Georgia. This lease, which we entered into in December 1998, was amended in February 2004, extending the expiration date of the lease to August 31, 2009.

We believe that our facilities are adequate for our current needs and do not anticipate inordinate difficulty in replacing such facilities or opening additional facilities, if needed.

Item 3. *Legal Proceedings.*

We are, from time to time, a party to litigation arising in the normal course of business. We do not believe that any of these actions, individually or in the aggregate, will have a material adverse affect on our financial position or results of operations.

Item 4. *Submission of Matters to a Vote of Security Holders.*

No matters were submitted to a vote of security holders of the company during the fourth quarter of the fiscal year covered by this report.

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PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters*.**

Our common stock trades on the NASDAQ under the symbol IDGR and prior to June 2, 2004, traded on the New York Stock Exchange, NYSE . The following table sets forth for the periods indicated the high and low closing market prices of the common stock on the NASDAQ and NYSE.

	Price Range	
	High	Low
2003		
First Quarter	$ 3.20	$ 2.80
Second Quarter	$ 3.04	$ 2.76
Third Quarter	$ 3.66	$ 2.90
Fourth Quarter	$ 6.55	$ 3.31
2004		
First Quarter	$ 8.39	$ 5.37
Second Quarter	$ 8.55	$ 6.95
Third Quarter	$ 9.72	$ 7.75
Fourth Quarter	$ 9.80	$ 8.30
2005		
First Quarter (through February 25)	$ 9.10	$ 7.18

As of February 25, 2005, there were 145 holders of record of our common stock. Investors who beneficially own our common stock that is held in street name by brokerage firms or similar holders are not included in this number. Accordingly, based upon the quantities of periodic reports requested by such brokerage firms in the past, we believe that the actual number of individual beneficial owners of our common stock exceeds 2,700.

We have not paid dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the growth, development, and expansion of our business and, accordingly, do not currently intend to declare or pay any dividends on our common stock for the foreseeable future. The declaration, payment, and amount of future dividends, if any, will be subject to the discretion of our Board of Directors and will depend upon our future earnings, results of operations, financial condition, and capital requirements, among other factors. Under Delaware law, we are prohibited from paying any dividends unless we have capital surplus or net profits available for this purpose. In addition, our credit agreement prohibits the payment of dividends.

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Item 6. ***Selected Financial Data.***

These selected financial data have been derived from our audited consolidated financial statements and should be read in conjunction with such financial statements and the notes thereto, and Management s Discussion and Analysis of Financial Condition and Results of Operations, included in Item 7 of this Report.

	Year Ended December 31,				
	2004	**2003(*)** ***(As Restated)***	**2002**	**2001**	**2000**
	(in thousands, except per share data)				
Statements of Income Data:					
Net sales	$ 529,175	$ 483,442	$ 492,450	$ 514,385	$ 546,681
Gross profit	115,712	107,893	109,406	114,521	123,142
Selling, general, and administrative expenses(**)	105,599	101,518	103,298	110,811	115,862
Impairment, severance, and litigation settlement expense	0	0	0	0	15,050
Operating income (loss)	10,113	6,375	6,108	3,710	(7,770)
Accounting change	0	0	(50,347)	0	0
Extraordinary item	0	0	0	0	(200)
Net earnings (loss) (excluding accounting change and extraordinary item)***	$ 7,314	$ 2,361	$ 1,598	$ (1,358)	$ (9,412)
Net earnings (loss) (including accounting change but excluding extraordinary item)**	7,314	2,361	(48,749)	(1,358)	(9,412)
Net earnings (loss)***	7,314	2,361	(48,749)	(1,358)	(9,612)
Earnings (loss) per common share:					
Basic (excluding extraordinary item)***	$ 0.78	$ 0.26	$ 0.18	$ (0.16)	$ (1.09)
Diluted (excluding extraordinary item)***	0.75	0.26	0.18	(0.16)	(1.09)
Basic (including accounting change but excluding extraordinary item)	0.78	0.26	(5.53)	(0.16)	(1.09)
Basic	0.78	0.26	(5.53)	(0.16)	(1.11)
Diluted (including accounting change but excluding extraordinary item)**	0.75	0.26	(5.44)	(0.16)	(1.09)
Diluted**	0.75	0.26	(5.44)	(0.16)	(1.11)
Balance Sheet Data:					
Working capital	$ 77,222	$ 74,708	$ 75,974	$ 79,907	$ 94,265
Property and equipment, net	7,277	7,161	11,274	13,077	15,446
Total assets	146,062	133,300	139,182	201,044	223,958
Long-term debt, including current portion	22,281	26,533	36,363	42,762	53,305
Stockholders equity	$ 64,783	$ 56,398	$ 52,660	$ 101,135	$ 102,115

(*) As of December 31, 2004, we restated our financial results for the year ended December 31, 2003 to correct an error related to the recording of certain accounts payable. The correction increased the Company s accounts payable and cost of sales for 2003 by $496. We also made correcting adjustments to depreciation expense in order for such amounts in 2003 to be consistent with the Company s property and equipment accounting policies, which resulted in a reduction of depreciation expense in 2003 by $155. These corrections resulted in a reduction of taxes payable of $148. These corrections in the aggregate reduce our previously reported net income for 2003 by $195, or $0.02 per diluted share.

(**) Beginning in 2003, we reclassified amortization of deferred loan costs from selling, general, and administrative expenses to interest expense. For the years ended December 31, 2002, 2001, and 2000, the amounts reclassified were $360, $317, and $139, respectively.

(***) On January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets and recorded a charge of $50,347 for impairment of goodwill. If we had applied the non-amortization provisions of SFAS No. 142 prior to January 1, 2002, net earnings and diluted earnings per share would have increased by approximately $1,289 ($0.15 per share) for the years ended December 31, 2001 and 2000, respectively.

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

In the following discussions, most percentage and dollar amounts have been rounded to aid presentation; as a result, all such figures are approximations. References to approximations have generally been omitted.

Restatement of Certain 2003 Results

As of December 31, 2004 we restated our financial results for the year ended December 31, 2003 to correct an error related to the recording of certain accounts payable. The correction increased our accounts payable and cost of sales for 2003 by $0.5 million. We also made correcting adjustments to depreciation expense in order for such amounts in 2003 to be consistent with our property and equipment accounting policies, which resulted in a reduction of depreciation expense in 2003 of $0.2 million. These corrections in the aggregate reduce previously reported net income for 2003 by $0.2 million, or $0.02 per diluted share. All amounts presented and discussed below reflect the restatement.

General Trends Affecting our Operations

In the last several years, MROP requirements of large and middle-market companies have moved towards a need for services that are customized for each company. In many cases, our customers needs are centered upon reducing overall MROP costs and increasing operating efficiencies. As a result, we have targeted sales through our FPS program as the principal growth area of our business, and our resulting services for many customers extend well beyond the traditional business of supplying MROP products on a timely basis at a favorable price.

In connection with distributing a full line of MROP products to meet the needs of manufacturers and other industrial users, we offer our customers a wide range of specialized business process outsourcing services through our FPS programs that relate to product selection and application and the customer s production processes that affect the utilization and costs of MROP supplies. These service offerings include storeroom management (commonly referred to as integrated supply), commodity management, bar code inventory replenishment, vending machines, e-business solutions and consulting services, among others. We were among the first MROP suppliers to offer these types of storeroom management arrangements to customers who desired to outsource all (or a substantial portion) of their MROP procurement and management functions. Drawing upon our experiences with storeroom management and specialized procurement and fulfillment services and our product knowledge, we have expanded our FPS program to meet the growing demand for a wide variety of MROP service offerings. As a result of the increased demand for FPS, we have positioned our sales and marketing efforts to focus on FPS as our major business strategy. We believe the success of our FPS-focused strategy depends in major part on continued training of our sales and marketing personnel as well as our successful design and implementation of MROP procurement solutions that customers desire.

As discussed elsewhere in this report, FPS is both a program comprising services that we offer to our customers as well as our approach to providing those services and MROP products. In the FPS program, we design and implement solutions individually tailored to accommodate each customer s particular MROP needs. While FPS sales and marketing is our major strategic focus, we continue to focus substantial attention on general sales of MROP products from stock or on a special order (non-stock) basis especially to the mid-market customer segment. General MROP sales have historically been our principal source of revenue, and we expect that they will remain a source of substantial revenue, even as we increase our FPS sales.

A summary review of our sales results for the past three years reflects the trend we see with respect to the demand for FPS services among our MROP customers, which we believe supports our recognition of a similar trend within the industry in general.

Our total sales for 2004, 2003, and 2002 were $529.2 million, $483.4 million, and $492.5 million, respectively. Of these amounts, FPS sales (including sales pursuant to storeroom management arrangements) have increased steadily, both in dollar value (even as total sales have declined) and as a percentage of total sales, as reflected in the following table. We expect the upward trend in FPS sales to continue for the foreseeable future.

	Year Ended December 31,					
	2004		2003		2002	
	Net Sales	% of Total	Net Sales	% of Total	Net Sales	% of Total
	(dollars in millions)					
FPS Sales, including storeroom management	$ 289.3	54.7%	$ 250.6	51.8%	$ 219.7	44.6%
General MROP Sales	239.9	45.3%	232.8	48.2%	272.8	55.4%
Total Net Sales	$ 529.2	100.0%	$ 483.4	100.0%	$ 492.5	100.0%

Certain Effects of our Increasing FPS Sales

We expect that our FPS sales will continue to increase, especially as a percentage of aggregate sales relative to General MROP sales. We expect this will occur in large part from the addition of new FPS customers. We also expect the purchasing patterns of our FPS customers to evolve and change as economic conditions change. As a result of these expected changes in our FPS sales, we may experience changes relative to prior years in measures such as (i) our cost of sales as a percentage of net sales and (ii) our selling, general and administrative expenses as a percentage of net sales.

These measures may change because of the nature of the revenue and cost components associated with FPS sales and General MROP sales. Specifically, in FPS arrangements in which we become the exclusive or primary supplier of a large volume of MROP products to a customer (as occurs with a storeroom management contract), we may include management fee revenues designed to cover our administrative and overhead costs and performance based revenues where we share a portion of the cost savings we obtain for our customer, commonly referred to as gain sharing. In addition, we often offer volume discounts on products to the customer as part of the overall arrangement to achieve mutually beneficial results for the customer and us. In FPS arrangements where we derive a portion of our revenues from management fees, the mix of product sales versus management fee and gain sharing revenues can cause our gross margin as a percentage of net sales to be higher even if our product sales are lower. Conversely, product discounts will yield a slightly lower gross margin from FPS sales as product volume increases relative to service and gain sharing revenues. The additional revenue sources from FPS arrangements will tend to increase gross margins if product volume under these arrangements remains the same relative to General MROP sales. As a result, our gross margins will most likely decline as this business grows.

Currently, our FPS arrangements typically yield a lower gross margin as a percentage of sales (due to increased product volume) than General MROP sales; however, these arrangements yield a higher operating margin than General MROP sales because our selling, general and administrative expenses are lower and more variable in FPS arrangements. At our storeroom management sites, many of our procurement support functions are performed at the customer s facility. We therefore incur relatively low fixed costs as a percentage of total costs at storeroom management sites in comparison to our General MROP business, which has a higher fixed cost structure. In addition, the costs of our associates are billed to our customers at most of our storeroom management sites. Because our selling, general and administrative expenses at storeroom management arrangements are variable, we can control them relative to the volume and activity of the site. This control over expenses leads to higher operating margins in storeroom management arrangements. To a lesser extent than with storeroom management arrangements, we may experience similar effects in connection with other FPS services arrangements.

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Results of Operations

The following table sets forth a summary of our operating data and shows this data as a percentage of net sales for the periods indicated:

	Year Ended December 31,					
	2004		2003 (As Restated)		2002	
	(dollars in thousands)					
Net sales	$ 529,175	100.0%	$ 483,442	100.0%	$ 492,450	100.0%
Cost of sales	413,463	78.1%	375,549	77.7%	383,044	77.8%
Gross profit	115,712	21.9%	107,893	22.3%	109,406	22.2%
Selling, general, and administrative expenses	105,599	20.0%	101,518	21.0%	103,298	21.0%
Operating income	10,113	1.9%	6,375	1.3%	6,108	1.2%
Interest expense	1,630	0.3%	2,278	0.5%	3,270	0.6%
Interest income	(24)	0.0%	(21)	0.0%	(3)	0.0%
Other (income) loss, net	(21)	0.0%	(30)	0.0%	(23)	0.0%
Earnings before taxes and cumulative effect of accounting change	8,528	1.6%	4,148	0.8%	2,864	0.6%
Provision for income taxes	1,214	0.2%	1,787	0.4%	1,266	0.3%
Earnings before cumulative effect of accounting change	7,314	1.4%	2,361	0.4%	1,598	0.3%
Cumulative effect of accounting change	0	0.0%	0	0.0%	(50,347)	(10.2%)
Net earnings (loss)	$ 7,314	1.4%	$ 2,361	0.4%	$ (48,749)	(9.9%)

2004 Compared to 2003

Net sales increased $45.7 million, or 9.5%, from $483.4 million in 2003 to $529.2 million in 2004. On a daily sales basis, revenues increased $0.2 million, or 9.9%, over the prior year. Total FPS sales grew $38.7 million, or 15.4%, to $289.3 million in 2004 as compared to 2003. As a percentage of total sales, FPS sales increased to 54.7% as compared to 51.8% in the prior year. The increase in FPS revenues was due to the net increase of 26 FPS sites since December 31, 2003. At December 31, 2004, we had 341 total FPS sites, including 97 full storeroom management arrangements. In addition, increased production levels and our efforts to increase market share resulted in improved sales at existing sites. We also experienced an increase in production levels at many of our General MROP customers, resulting in an increase in General MROP sales of $7.0 million, or 3.0%, from $232.8 million in 2003 to $239.9 million in 2004. Most of the latter such increase occurred primarily as a result of increased volume at existing accounts.

Cost of sales increased by $37.9 million, or 10.1%, from $375.5 million in 2003 to $413.5 million in 2004. As a percentage of net sales, cost of sales increased from 77.7% in 2003 to 78.1% in 2004. The greater percentage increase of cost of sales relative to net sales from 2003 to 2004 was primarily the result of lower gross margins on our General MROP sales, which reflects the results of intense competitive pricing in the market for business. This amount was partially offset by an incremental $0.3 million in year end rebates, and a $0.2 decrease in inventory reserves as compared to the prior year. In addition, approximately 0.1% of the overall decrease in gross margins was due to the shift in sales mix from General MROP sales towards FPS sales as discussed above. This is because, as a general matter, our FPS arrangements typically yield a lower gross margin than do our General MROP sales, due to lower prices in exchange for the exclusive relationship in these arrangements. On the other hand, our FPS arrangements typically yield a higher operating margin than General MROP sales because our FPS sales generally have lower fixed costs.

Selling, general and administrative expenses increased $4.1 million, or 4.0%, from $101.5 million in 2003 to $105.6 million in 2004. The increase in selling, general and administrative expenses in 2004 was primarily the result of an increase of $5.4 million in variable selling expenses associated with the higher sales volume, including (i) salaries, commissions, and additional incentives of $4.3 million due to improved operating performance, (ii) increased freight and delivery expense of $0.6 million, and (iii) increased travel expenses of $0.5 million. These additional expenses were partially offset by a decrease in occupancy expense of $1.3 million due to our facility rationalization program. We now have 41 facilities as compared to 46 a year ago.

Operating income increased $3.7 million, or 58.6%, from $6.4 million in 2003 to $10.1 million in 2004. This increase was primarily due to the increase in sales volume, which was only partially offset by a decrease in gross margin and an increase in selling, general, and administrative expenses as noted above.

Interest expense decreased by $0.6 million, or 28.4%, from $2.3 million in 2003 to $1.6 million in 2004. The savings in interest expense was attributable to a 0.5% decrease in the average monthly interest rate on our Credit Facility since December 31, 2003, as a result of lower LIBOR rates and favorable pricing due to improved operating results; and to a reduction in the average amount of long-term debt outstanding during 2004 relative to 2003, to $31.8 million from $37.7 million.

The provision for income taxes decreased by $0.6 million from $1.8 million in 2003 to $1.2 million in 2004, or from 43.1% to 14.2%, respectively. The decrease reflects a $2.6 million reduction of our valuation allowance for our deferred tax asset associated with future deductible goodwill amortization and state net operating loss carryforwards, both of which we believe it is more likely than not we will realize in the future, as explained in Note 2 to our financial statements (F-9). That adjustment to our deferred tax asset was a non-recurring benefit. Our effective tax rate for 2004 decreased to 14.2% as compared to 43.1% due primarily to the reduction in the valuation allowance which reduced the tax rate by 30.4% effect of reduction in our 2004 rate.

2003 Compared to 2002

Net sales decreased $9.0 million, or 1.8%, from $492.5 million in 2002 to $483.4 million in 2003. The decline in sales was directly related to the prolonged downturn in the economy that affected most of our customer base, but especially our customers in the energy, aerospace and automotive industries. Many customers in manufacturing sectors reduced production levels further and experienced more extended plant shutdowns in 2003 as compared to the prior year. In addition, many local competitors offered discounted prices that appeared more favorable to some customers than ours, resulting in our loss of market share. As a result of these factors, our General MROP revenues decreased $40.0 million, or 14.7%, from $272.8 million in 2002 to $232.8 million in 2003. Partially offsetting the decline in General MROP sales, our total FPS sales increased by $30.9 million, or 14.1%, from $219.7 million in 2002 to $250.6 million in 2003. FPS sales as a percentage of total sales increased to 51.8%, as compared to 44.6% in the prior year. Specifically, storeroom management sales accounted for $192.1 million, or 39.7%, of total sales in 2003. During 2003, we added 13 new storeroom management sites at six new customers, and increased our total to 105 storeroom management sites for 59 customers.

Cost of sales decreased by $7.5 million, or 2.0%, from $383.0 million in 2002 to $375.5 million in 2003. As a percentage of net sales, cost of sales decreased slightly from 77.8% in 2002 to 77.7% in 2003. Inventory reserve expense decreased by $1.0 million primarily due to our success in return-to-vendor programs, which was the driver of the decrease in cost of goods sold as a percentage of net sales. Although gross margins improved since the prior year, it is important to note that due to a shift in sales mix from General MROP sales towards FPS sales, there was some downward pressure on gross margin which we expect will continue as FPS sales grow. This is because our FPS arrangements typically yield a lower gross margin than do our General MROP sales, due to lower prices in exchange for the exclusive relationship in these arrangements. On the other hand, our FPS arrangements typically yield a higher operating margin than General MROP sales because our FPS sales generally have lower fixed costs. There was also negative impact from competitive pricing pressure, which made up $0.5 million of the variance. The overall impact of the shift in mix and pricing pressures was approximately 0.4%, which was more than offset by reduced inventory expense as mentioned above.

Selling, general and administrative expenses decreased $1.8 million, or 1.7%, from $103.3 million in 2002 to $101.5 million in 2003; but as a percentage of net sales, such expenses remained constant due to lower sales volume. In 2003, we decreased selling, general and administrative expenses despite the cessation of our company-wide furloughs program, which generated $1.3 million in temporary savings in 2002. Excluding the effect of furloughs in 2002, selling, general and administrative expenses decreased by $3.1 million, or 3.0%, as compared to 2002. Salaries and benefits, excluding the effect of furloughs, were stable in 2003 as compared to the prior year, as we

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were able to maintain the savings realized in 2002 resulting from headcount reductions made. Overall, the reduction in selling, general and administrative expenses in 2003 was the combined result of lower bad debt expense of $1.1 million, lower information technology and telecommunications expense of $0.7 million due to contract renegotiations, and a $0.7 million reduction in delivery and freight expense. Additionally, in 2003 we realized savings of $0.3 million in occupancy costs associated with our facility rationalization program and a savings in depreciation expense of $0.2 million for the year.

Operating income increased $0.3 million, or 4.4%, from $6.1 million in 2002 to $6.4 million in 2003. This result was primarily attributable to the reduction of selling, general and administrative expenses from 2002 to 2003, which was partially offset by the reduction in our sales volume.

Interest expense decreased by $1.0 million, or 30.3%, from $3.3 million in 2002 to $2.3 million in 2003. The significant savings in interest expense was attributable to a 0.9% decrease in the average monthly interest rate on our credit facility since December 31, 2002, as a result of lower LIBOR rates; favorable pricing associated with our debt agreement renewal in May 2003; and a reduction in the average amount of long-term debt outstanding during 2003 relative to 2002, to $37.7 million from $40.9 million. We also realized $0.1 million of additional savings due to the pay-off of our premium financing agreement.

The provision for income taxes increased by $0.5 million from $1.3 million in 2002 to $1.8 million in 2003, as a result of more profitable operations in 2003. Our tax rate decreased from 44.2% in 2002 to 43.1% in 2003.

On January 1, 2002 we adopted SFAS No. 142, which resulted in a non-cash charge to write-off goodwill net of accumulated amortization of $50.3 million, which was recorded as a cumulative effect of accounting change.

Liquidity and Capital Resources

Capital Availability and Requirements

At January 31, 2005, our total working capital was $84.2 million, which included $3.9 million in cash and cash equivalents. We had $30.5 million outstanding under our $100 million revolving credit facility with a syndicate of commercial banks (the Credit Facility) and an aggregate of $69.5 million of borrowing capacity under that facility. Based upon our asset base and outstanding borrowings under the Credit Facility, we had borrowing capacity of $28.0 million.

Our Credit Facility was amended in 2004 to extend its term to May 28, 2006. The Credit Facility may be used for operations and acquisitions, and provides $5 million for swinglines and $10 million for letters of credit. Amounts outstanding under the Credit Facility bear interest at either the lead bank s corporate rate or LIBOR, plus applicable margins, as we may select from time to time. We incur a fee between 25 and 37.5 basis points on the average daily-unused capacity during the term. Assets of all our subsidiaries secure the Credit Facility. We are also subject to certain financial covenants regarding fixed charges coverage, capital expenditures, and tangible net worth, which could affect our borrowing base under the Credit Facility. Our average borrowing rate is currently 4.4%.

The principal financial covenants under our Credit Facility require a fixed charge coverage ratio of 1.1:1.0 and capital expenditures of no more than $6.5 million in any twelve-month period. Our fixed charge coverage ratio was 1.6:1.0 at December 31, 2004, and our capital expenditures were $1.0 million for the twelve month period ended December 31, 2004. Our covenants require a minimum tangible net worth of $48.0 million; at December 31, 2004, our tangible net worth was $64.5 million. We are presently in compliance with all covenants under the Credit Facility and anticipate that we will remain in compliance with the covenants.

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The table below outlines our contractual cash obligations, excluding interest, as they come due.

	Payments Due by Period (in thousands)						
Contractual Obligations	**Total**	**2005**	**2006**	**2007**	**2008**	**2009**	**Thereafter**
Long Term Debt	$ 22,281	$ 196	$ 21,784	$ 60	$ 52	$ 38	$ 151
Operating Leases	$ 28,677	$ 5,545	$ 4,863	$ 3,864	$ 3,209	$ 1,799	$ 9,397
Total Contractual Cash Obligations	$ 50,958	$ 5,741	$ 26,647	$ 3,924	$ 3,261	$ 1,837	$ 9,548

Our principal ongoing capital requirements at the present time are for servicing our outstanding debt as reflected in the above table, carrying inventory and accounts receivable, and purchasing and upgrading information technology and equipment. We believe that cash flow from operations and the use of available capacity under our Credit Facility will be adequate to meet our obligations set forth above and to fund both our current operations and anticipated internal expansion for at least the current year. We may consider a strategic acquisition opportunity if presented; in such case, cash financing would probably be necessary, and we would need approval from our current lenders or access to other capital sources in order to do so.

Purchase orders or contracts for the purchase of inventory and other goods and services are not included in the table above. We are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as purchase orders may represent authorizations to purchase rather than binding agreements. Our purchase orders are based on our current distribution needs and are fulfilled by our vendors within short time horizons. We do not have significant agreements for the purchase of inventory or other goods specifying minimum quantities or set prices that exceed our expected requirements for three months.

Analysis of Cash Flows

On a historical basis, net cash provided by operating activities for fiscal years 2004, 2003, and 2002 was $7.3 million, $7.4 million, and $10.4 million, respectively. In 2004, cash provided by operations was primarily the result of the increase in business activity and profitability that increased net income. Our increase in sales volume in 2004 resulted in more cash used by accounts receivable; however, this was primarily offset by cash provided by accounts payable due to increased purchases to service the increased volume. When compared to 2003, overall cash flow from operations decreased slightly in 2004, but cash flow from operations in 2004 was primarily due to increased net income from increased sales volume and expansion of our business in 2004. The comparatively stronger performance in 2003 on this measure, while our sales volume and level of business activity were lower in 2003 than in 2004, is primarily the result of (i) our improved working capital management procedures instituted in 2003 that affected both accounts receivable and inventory and (ii) our facilities rationalization and product management programs. Also in 2003, cash was used by accounts payable because we lowered purchases to adjust to current sales levels. From 2003 to 2002, cash flow from operating activities decreased due to the decline in business activity and corresponding working capital needs.

Net cash (used in) provided by investing activities for fiscal years 2004, 2003, and 2002 was ($0.9 million), $2.6 million, and ($0.5 million), respectively. During 2004, we used cash primarily for the purchase of computers and related IT equipment. During 2003, we received cash of $3.0 million, net of closing costs, as a result of the sale of three facilities. Cash used for capital expenditures in 2003 was $0.5 million as compared to $0.6 million in 2002. During 2002, we used cash in investing activities primarily for capital expenditures.

Net cash used in financing activities for fiscal years 2004, 2003, and 2002 was $3.5 million, $10.1 million, and $9.9 million, respectively. Our primary use of cash in financing activities in 2004 was for repayment of borrowings under our Credit Facility. During 2003, our primary use of cash in financing activities was for repayment of borrowings under our Credit Facility and payments under our management liability insurance. Additionally, in 2003 we used $1.2 million of cash to retire a mortgage associated with the sale of a facility. As compared to 2002, there was a reduction in 2003 in cash used to pay for the management liability insurance, which was retired in March 2003. During 2002, we used cash in financing activities primarily for repayment of borrowings under our Credit facility, and other long-term debt repayments.

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Certain Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires our management to make estimates and assumptions that affect: the reported amounts of assets and liabilities at the date of the financial statements; the disclosure of contingent assets and liabilities at the date of the financial statements; and the reported amounts of revenues and expenses during the reporting period. Our management regularly evaluates its estimates and assumptions. These estimates and assumptions are based on historical experience and on various other factors that are believed to be reasonable under the circumstances, and form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

While our significant accounting policies are described in Note 2 of Notes to Consolidated Financial Statements, we believe that the following accounting policies and estimates involve a higher degree of complexity and warrant specific description.

Allowance for Doubtful Accounts   Methodology

We have established an allowance for uncollectible accounts based on our collection experience and an assessment of the collectibility of specific accounts. We evaluate the collectibility of accounts receivable based on a combination of factors. Initially, we estimate an allowance for doubtful accounts as a percentage of accounts receivable based on historical collections experience. This initial estimate is periodically adjusted when we become aware of a specific customer s inability to meet its financial obligations (e.g., a bankruptcy filing or announced insolvency) or as a result of changes in the overall aging of accounts receivable. We do not believe our estimate of the allowance for doubtful accounts is likely to be adversely affected by any individual customer, since our customers are geographically disbursed and we have no individually significant customers. We recorded bad debt expense of $0.8 million, $0.8 million, and $2.1 million in 2004, 2003, and 2002, respectively. During 2004, 2003, and 2002, we wrote off $2.5 million, $0.3 million, and $0.5 million, respectively, against our reserves for accounts receivable. The write offs recorded in 2004 reflect a revision in our policy, adopted October 1, 2004, that uncollectible accounts over two years old should be removed from our accounts receivable balance. This change in policy had no effect on either our results from operations or cash flows. Our reserve for accounts receivable was approximately $2.1 million and $3.7 million at December 31, 2004 and 2003, or 3.1% and 6.1% of gross receivables, respectively.

Inventories   Slow Moving and Obsolescence

In connection with certain contracts, we maintain certain special inventories for specific customers needs. In certain contracts, the customers are required to purchase the special inventory at the time that the inventory reaches a certain age. However, for other customer relationships and inventories, we are not protected from the risk of inventory loss. In such cases, we rely on available return privileges with vendors, if any. Therefore, in determining the net realizable value of inventories, we identify slow moving or obsolete inventories that (i) are not protected by our customer agreements from risk of loss, and (ii) are not eligible for return under various vendor return programs. Based upon these factors, we estimate the net realizable value of inventories and record any necessary adjustments as a charge to cost of sales. If our inventory return privileges were discontinued in the future, or if customers were unable to honor the provisions of certain contracts that protect us from inventory losses, our risk of loss associated with obsolete or slowing moving inventories would increase. We recorded inventory (recoveries) or expense for ($0.2 million), ($0.1 million), and $1.0 million, in 2004, 2003 and 2002, respectively. We wrote off $0.2 million, $1.1 million, and $1.7 million against our reserves for excess and obsolete inventories during 2004, 2003, and 2002, respectively. Our reserve for obsolete and slowing moving inventories was approximately $5.2 million and $5.6 million at December 31, 2004 and 2003, or 8.3% and 9.1% of gross inventories, respectively.

Impairment of Long-Lived Assets

We periodically evaluate property and equipment for potential impairment indicators. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance.

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Future events could cause us to conclude that impairment indicators exist and that assets associated with a particular operation are impaired. Evaluating the impairment also requires us to estimate future operating results and cash flows, which also require judgment by management. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Deferred Income Tax Assets

We have net deferred tax assets, which are subject to periodic recoverability assessments. The factors used to assess the likelihood of realization of these net deferred tax assets are the reversal of taxable temporary differences, our forecast of future taxable income (which is based upon estimates and assumptions), and available tax planning strategies that could be implemented to realize the net deferred tax assets. On the basis of the improved operating results and projections for future taxable income, we believe it is more likely than not that our future operations will generate sufficient taxable income to realize our net deferred tax assets. If these estimates and related assumptions change in the future, we may be required to record an additional valuation allowance against our deferred tax assets, resulting in additional income tax expense in our consolidated statements of income. We evaluate the realizability and appropriateness of our deferred tax assets and liabilities quarterly and assess the need for any valuation allowance against deferred tax assets. During 2004 we determined that the future tax benefits associated with deductible goodwill amortization for tax purposes became fully realizable. Due to the extended reversal period and the uncertainty of projecting future taxable income over this period, the deferred tax asset associated with the goodwill amortization had been fully reserved for with a valuation allowance. We made this determination primarily based on our projections of the future taxable income over the reversal period. This resulted in a $2.0 million (or $0.20 per diluted share for the year) reduction of the valuation allowance and an associated reduction of income tax expense for the year. We also reduced the valuation allowance by an additional $0.6 million (or $0.07 per diluted share for the year) for state net operating losses which became fully realizable during the year. In the future, if it becomes more likely than not that we will be able to utilize certain deferred tax benefits that are presently reserved with a valuation allowance, or that there may be certain deferred tax liabilities that arise, we may adjust the valuation allowance accordingly. In addition, if we experience a decline in earnings in the future, we may have to increase the valuation allowance. The remaining $0.6 million balance in the valuation allowance is for certain state net operating loss carryforwards.

Self insurance and related reserves

We are self-insured for certain losses relating to group health, worker s compensation, and casualty losses, subject to stop loss limits. We utilize third party administrators to process and administer all related claims. We accrue an estimate for incurred but not reported claims and related expenses based upon historical experience. The accrual for incurred but not reported claims relating to group health, worker s compensation, and casualty losses totaled approximately $1.5 million at December 31, 2004 and December 31, 2003. The accuracy of our accrual for incurred but not reported claims is entirely dependent on future events that are subject to change. Because we are self-insured, an increase in the volume or severity of claims in the future may cause us to record additional expense that was not estimable at December 31, 2004. We are not aware of any increasing volume or severity of individual claims.

Item 7A. *Quantitative and Qualitative Disclosures about Market Risk.*

We believe that our exposures to market risks are immaterial. We hold no market risk sensitive instruments for trading purposes. At present, we do not employ any derivative financial instruments, other financial instruments, or derivative commodity instruments to hedge any market risk, and we have no plans to do so in the future. To the extent we have borrowings outstanding under our Credit Facility, we are exposed to interest rate risk because of the variable interest rate under the facility.

Item 8. ***Financial Statements and Supplementary Data.***

The information required to be provided by this item is found on pages F-1 through F-22 of this Report.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Procedures.***

None.

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Item 9A. ***Controls and Procedures.***

An evaluation was performed under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14(c) under the Securities Exchange Act of 1934 (the Act) as of the end of the period covered by this report. Based on that evaluation, our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report in accumulating and communicating information to our management, including our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures of that information under the Securities and Exchange Commission s rules and forms and that our disclosure controls and procedures are designed to ensure that the information we are required to disclose in reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms.

We point out, however, that the errors we discovered in how one of our four regional divisions was recording account payable which led to the restatement of certain aspects of our 2003 financial results (and correcting adjustments to our quarterly results for the first three quarters of 2004) that are reflected and discussed in Items 6 and 7 were not discovered by our disclosure controls and procedures as they operated at such earlier times prior to the end of the period covered by this report.

PART III

Item 10. ***Directors and Executive Officers of the Registrant.***

The information contained under the heading Election of Directors in the definitive Proxy Statement to be used in connection with the solicitation of proxies for the Company s 2005 Annual Meeting of Stockholders, to be filed with the Commission, is incorporated herein by reference. Pursuant to instruction 3 to paragraph (b) of Item 401 of Regulation S-K, information relating to the executive officers of the Company is included in Item 1 of this Report.

Item 11. ***Executive Compensation.***

The information contained under the heading Executive Compensation in the definitive Proxy Statement to be used in connection with the solicitation of proxies for the Company s 2005 Annual Meeting of Stockholders, to be filed with the Commission, is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.***

The information contained under the headings Voting Securities and Principal Stockholders and Equity Compensation Awards in the definitive Proxy Statement to be used in connection with the solicitation of proxies for the Company s 2005 Annual Meeting of Stockholders, to be filed with the Commission, is incorporated herein by reference. For purposes of determining the aggregate market value of the Company s voting stock held by nonaffiliates, shares held by all directors and executive officers of the Company have been excluded. The exclusion of such shares is not intended to, and shall not, constitute a determination as to which persons or entities may be affiliates of the Company as defined by the Commission.

Item 13. ***Certain Relationships and Related Transactions.***

The information contained under the heading Certain Transactions in the definitive Proxy Statement to be used in connection with the solicitation of proxies for the Company s 2005 Annual Meeting of Stockholders, to be filed with the Commission, is incorporated herein by reference.

Item 14. ***Principal Accountants Fees and Services***

The information contained under the heading Independent Auditors in the definitive Proxy Statement to be used in connection with the solicitation of proxies for the Company s 2005 Annual Meeting of Stockholders, to be filed with the Commission, is incorporated herein by reference.

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PART IV

Item 15. ***Exhibits and Financial Statement Schedule***

The following financial statements and notes thereto and financial statement schedules are filed as part of this Report:

1. Financial Statements

2. Financial Statement Schedule

All other schedules have been omitted because any information required is included in the financial statements or notes.

Exhibits

The exhibits set forth below are required to be filed with this Report pursuant to Item 601 of Regulation S-K:

Exhibit Number	Description of Exhibit
3.1	Certificate of Incorporation, as amended, of the Company (filed as Exhibit 3.1 of the Company s Registration Statement on Form S-1 (File No. 333-36233) is hereby incorporated by reference)
3.2	Bylaws of the Company (filed as Exhibit 3.2 of the Company s Registration Statement on Form S-1 (File No. 333-36233) is hereby incorporated by reference)
4.1	Form of Common Stock Certificate of the Company (filed as Exhibit 4.1 of the Company s Registration Statement on Form 8-A (File No. 001-13195) on August 31, 2000 is hereby incorporated by reference)
4.2	Certificate of Designation (filed as Exhibit 4.2 of the Company s Current Report on Form 8-K (File No. 001-13195) is hereby incorporated by reference)
(*)10.1(a)	Industrial Distribution Group, Inc. Stock Incentive Plan (filed as Exhibit 10.5 of the Company s Registration Statement on Form S-1 (File No. 333-36233) is hereby incorporated by reference)
(*)10.1(b)	Amendment No. 1 to Industrial Distribution Group, Inc. Stock Incentive Plan (filed as Exhibit 10.5b) of the Company s Annual Report on Form 10-K (File No. D01-131950) on March 31, 1999 is hereby incorporated by reference)

(*)10.2	Form of Indemnification Agreement entered into between the Company and each of the executive officers and directors of the Company (filed as Exhibit 10.9 of the Company s Registration Statement on Form S-1 (File No. 333-36233) is hereby incorporated by reference)
10.3	Lease Agreement dated July 30, 1998 by and between Andrew B. and Stephanie A. Shearer and Shearer Industrial Supply Co. (filed as Exhibit 10.12 of the Company s Registration Statement on Form S-1 (File No. 333-51851) is hereby incorporated by reference)

Exhibit Number	Description of Exhibit
	incorporated by reference)
10.5(a)	Credit Agreement dated December 22, 2000 by and between the Company, the lenders listed therein, and First Union National Bank (filed as Exhibit 10.6 of the Company s Annual Report on Form 10-K (File No. 001-13195) on March 28, 2001 is hereby incorporated by reference)
10.5(b)	Credit Agreement Amendment dated August 1, 2001 by and between the Company, the lenders listed therein, and First Union National Bank (filed as Exhibit 10.5(b) of the Company s Annual Report on Form 10-K (File No. 001-13195) on March 29, 2002 is hereby incorporated by reference)
10.5(c)	Second Amendment to Credit Agreement dated May 28, 2003 by and between the Company, Wachovia Bank, National Association (formerly First Union National Bank) and the lenders listed therein (filed as Exhibit 10.1 of the Company s Quarterly Report on Form 10-Q (File No. 001-13195) on July 31, 2003 is hereby incorporated by reference)
10.6	Rights Agreement dated as of August 28, 2000 by and between the Company and American Stock Transfer & Trust Company (filed as Exhibit 10.1 of the Company s Registration Statement on Form 8-A (File No. 001-13195) on August 31, 2000 is hereby incorporated by reference)
(*)10.7	Form of Restricted Stock Agreements (filed as Exhibit 10.7 of the Company s Annual Report on Form 10-K (File No. 001-13195) on March 21, 2003 is hereby incorporated by reference)
21.1	Subsidiaries of the Company
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer with respect to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
31.2	Certification of Chief Financial Officer with respect to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
32.1	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of United States Code by Chief Executive Officer with respect to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
32.2	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of United States Code by Chief Financial Officer with respect to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

(*) Management contract or compensatory plan or arrangement required to be filed as an exhibit.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(a) 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 in the City of Atlanta, State of Georgia, on the 11th day of March 2005.

INDUSTRIAL DISTRIBUTION GROUP, INC.

By: /s/ Andrew B. Shearer

Andrew B. Shearer
President and Chief Executive Officer

Signature	Position
/s/ Andrew B. Shearer Andrew B. Shearer	President, Chief Executive Officer, and Director (Principal Executive Officer)
/s/ Jack P. Healey Jack P. Healey	Senior Vice President, Chief Financial Officer, and Secretary (Principal Financial and Accounting Officer)
/s/ Richard M. Seigel Richard M. Seigel	Chairman of the Board
/s/ David K. Barth David K. Barth	Director
/s/ William J. Burkland William J. Burkland	Director
/s/ William R. Fenoglio William R. Fenoglio	Director
/s/ William T. Parr William T. Parr	Director
/s/ George L. Sachs, Jr.	

George L. Sachs, Jr.	Director

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INDEX TO FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of

Industrial Distribution Group, Inc.:

We have audited the accompanying consolidated balance sheets of Industrial Distribution Group, Inc. and Subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These consolidated financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Industrial Distribution Group, Inc. and Subsidiaries at December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ending December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule for the three years ended December 31, 2004, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1, the Company restated its 2003 financial statements to correct errors related to the recording of accounts payable, cost of sales, property and equipment, and depreciation expense.

As discussed in Note 2, on January 1, 2003 the Company changed its method of accounting for stock-based compensation. In addition, as discussed in Note 2, on January 1, 2002, the Company changed its method of accounting for goodwill.

/s/ Ernst & Young LLP

Atlanta, Georgia
March 10, 2005

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INDUSTRIAL DISTRIBUTION GROUP, INC.
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2004 AND 2003
(in thousands, except share data)

	2004	2003 *(As Restated-See Note 1)*
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 3,164	$ 337
Accounts receivable, net	64,582	57,107
Inventories, net	56,835	56,011
Deferred tax assets	4,363	5,019
Prepaid and other current assets	6,144	5,598
Total current assets	135,088	124,072
PROPERTY AND EQUIPMENT, NET	7,277	7,161
INTANGIBLE ASSETS, NET	243	287
DEFERRED TAX ASSETS	2,463	784
OTHER ASSETS	991	996
Total assets	$ 146,062	$ 133,300
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 196	$ 185
Accounts payable	47,960	39,669
Accrued compensation	4,095	2,231
Other accrued liabilities	5,615	7,279
Total current liabilities	57,866	49,364
LONG-TERM DEBT, NET OF CURRENT PORTION	22,085	26,348
OTHER LONG TERM LIABILITIES	1,328	1,190
Total liabilities	81,279	76,902
COMMITMENTS AND CONTINGENCIES (NOTE 10)		
STOCKHOLDERS EQUITY (NOTE 13):		
Preferred stock, $0.10 par value per share; 10,000,000 shares authorized, no shares issued or outstanding in 2004 and 2003	0	0

Common stock, $0.01 par value per share; 50,000,000 shares authorized, 9,343,850 issued and outstanding in 2004, 9,187,735 shares issued and outstanding in 2003	93		92
Additional paid-in capital	100,700		99,342
Unearned compensation	(405)		(117)
Accumulated deficit	(35,605)		(42,919)
Total stockholders equity	64,783		56,398
Total liabilities and stockholders equity	$ 146,062	$	133,300

The accompanying notes are an integral part of these consolidated balance sheets.

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**INDUSTRIAL DISTRIBUTION GROUP, INC.
AND SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003, AND 2002
(in thousands, except share data)

	2004	2003 (As Restated-See Note 1)	2002
NET SALES	$ 529,175	$ 483,442	$ 492,450
COST OF SALES	413,463	375,549	383,044
Gross profit	115,712	107,893	109,406
SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES	105,599	101,518	103,298
Operating income	10,113	6,375	6,108
INTEREST EXPENSE	1,630	2,278	3,270
INTEREST INCOME	(24)	(21)	(3)
OTHER INCOME, NET	(21)	(30)	(23)
EARNINGS BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE, AND INCOME TAXES	8,528	4,148	2,864
PROVISION FOR INCOME TAXES	1,214	1,787	1,266
EARNINGS BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE	7,314	2,361	1,598
CUMULATIVE EFFECT OF ACCOUNTING CHANGE	0	0	(50,347)
NET EARNINGS (LOSS)	$ 7,314	$ 2,361	$ (48,749)
EARNINGS (LOSS) PER COMMON SHARE:			
Basic			
Earnings before cumulative effect of accounting change	$ 0.78	$ 0.26	$ 0.18
Cumulative effect of accounting change	0.00	0.00	(5.71)
Net earnings (loss)	$ 0.78	$ 0.26	$ (5.53)
Diluted			
Earnings before cumulative effect of accounting change	$ 0.75	$ 0.26	$ 0.18
Cumulative effect of accounting change	0.00	0.00	(5.62)
Net earnings (loss)	$ 0.75	$ 0.26	$ (5.44)
WEIGHTED AVERAGE SHARES:			
Basic	9,339,276	8,991,822	8,823,982

Diluted	9,704,243	9,141,049	8,962,003

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

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**INDUSTRIAL DISTRIBUTION GROUP, INC.
AND SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003, AND 2002
(in thousands, except share data)

	COMMON STOCK SHARES	COMMON STOCK AMOUNT	ADDITIONAL PAID-IN CAPITAL	UNEARNED COMPENSATION	ACCUMULATED EARNINGS (DEFICIT)	TOTAL
BALANCE, DECEMBER 31, 2001	8,724,184	$ 87	$ 97,579	$ 0	$ 3,469	$ 101,135
Issuance of shares pursuant to executive restricted stock agreement	0	0	246	(246)	0	0
Sale of shares through employee stock purchase plan	133,638	1	224	0	0	225
Stock options exercised	2,251	0	4	0	0	4
Amortization of unearned compensation	0	0	0	45	0	45
Net loss	0	0	0	0	(48,749)	(48,749)
BALANCE, DECEMBER 31, 2002	8,860,073	88	98,053	(201)	(45,280)	52,660
Sale of shares through employee stock purchase plan	93,719	1	233	0	0	234
Stock options exercised	233,943	3	836	0	0	839
Stock based compensation	0	0	40	0	0	40
Tax benefit from stock options exercised	0	0	180	0	0	180
Amortization of unearned compensation	0	0	0	84	0	84
Net earnings *(As Restated-See Note 1)*	0	0	0	0	2,361	2,361
BALANCE, DECEMBER 31, 2003 *(As Restated-See Note 1)*	9,187,735	92	99,342	(117)	(42,919)	56,398
Issuance of shares pursuant to executive restricted stock agreement	0	0	433	(433)	0	0
Sale of shares through employee stock purchase plan	59,481	0	280	0	0	280
Stock options exercised	96,634	1	314	0	0	315
Stock based compensation	0	0	137	0	0	137
Tax benefit from stock options exercised	0	0	225	0	0	225

Adjustment to deferred compensation for cancellations	0	0	(31)	31	0	0
Amortization of unearned compensation	0	0	0	114	0	114
Net earnings	0	0	0	0	7,314	7,314
BALANCE, DECEMBER 31, 2004	9,343,850	$ 93	$ 100,700	$ (405)	$ (35,605)	$ 64,783

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

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INDUSTRIAL DISTRIBUTION GROUP, INC.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003, AND 2002
(in thousands)

	2004	2003 *(As Restated-See Note 1)*	2002
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings (loss)	$ 7,314	$ 2,361	$ (48,749)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation and amortization	909	2,305	2,810
Amortization of unearned compensation	114	84	45
Gain on sale of assets	(66)	(404)	(43)
Deferred income taxes	(1,023)	597	1,087
Income tax benefit of stock options exercised	225	180	0
Impairment of goodwill	0	0	50,347
Changes in operating assets and liabilities:			
Accounts receivable, net	(7,475)	523	2,117
Inventories, net	(824)	1,554	4,342
Prepaids and other assets	(561)	(959)	1,722
Accounts payable	8,291	(582)	(2,266)
Accrued compensation	1,864	352	307
Other accrued liabilities	(1,513)	1,373	(1,297)
Total adjustments	(59)	5,023	59,171
Net cash provided by operating activities	7,255	7,384	10,422
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property and equipment, net	(1,040)	(495)	(613)
Proceeds on sale of investments	5	0	0
Proceeds from the sale of property and equipment	127	3,055	72
Net cash (used in) provided by investing activities	(908)	2,560	(541)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock, net of issuance cost	732	1,113	229
Repayments on revolving credit facility	(113,160)	(125,350)	(151,665)
Borrowings on revolving credit facility	109,010	117,300	145,965

Short-term debt borrowings	11	0	0
Long-term debt repayments	(113)	(1,780)	(699)
Premium payments on management liability insurance	0	(930)	(3,720)
Deferred loan costs and other	0	(412)	(15)
Net cash used in financing activities	(3,520)	(10,059)	(9,905)
NET CHANGE IN CASH AND CASH EQUIVALENTS	2,827	(115)	(24)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	337	452	476
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 3,164	$ 337	$ 452
SUPPLEMENTAL DISCLOSURES:			
Interest paid	$ 1,289	$ 1,588	$ 2,048
Income taxes paid (refunded)	$ 4,478	$ (550)	$ (744)

The accompanying notes are in integral part of these consolidated statements.

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**INDUSTRIAL DISTRIBUTION GROUP, INC.
AND SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AND SCHEDULE

DECEMBER 31, 2004, 2003, AND 2002

1. BASIS OF PRESENTATION

Organization and Business

Industrial Distribution Group, Inc. (IDG or the Company), a Delaware corporation, was formed on February 12, 1997 to create a nationwide supplier of cost-effective, Flexible Procurement Solutions for manufacturers and other users of maintenance, repair, operating, and production (MROP) products. The Company conducts business in all 50 states and two foreign countries, providing expertise in the procurement, management, and application of MROP products to a wide range of industries.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All significant intercompany accounts and transactions have been eliminated in consolidation.

Certain amounts in the 2002 financial statements were reclassified to conform to the 2003 presentation. The effects of the reclassifications on the overall financial statement presentation are not significant, except for the items discussed below. In the 2002 statement of operations, the Company reclassified the amortization of deferred loan costs of approximately $360,000 from selling, general and administrative expenses to interest expense.

Restatement of Fiscal Year 2003

The Company restated its financial results for the year ended December 31, 2003 due to the correction of an error related to the recording of certain accounts payable. The correction increased the Company s accounts payable and cost of sales for 2003 by $496,000. The Company also made correcting adjustments to its depreciation expense in order for prior periods to be consistent with the Company s property and equipment accounting policies, which resulted in a reduction of depreciation expense and an increase of net property and equipment in 2003 of $155,000. For fiscal year 2003, these corrections in the aggregate reduced the Company s previously reported net income by $195,000, or $0.02 per diluted share.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, and the differences could be material.

Cash Equivalents

The Company considers all short-term investments with original maturities of three months or less to be cash equivalents.

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Accounts Receivable

Accounts receivable is composed of trade receivables that are credit based and do not require collateral. An allowance for doubtful accounts has been established based on the Company s collection experience and an assessment of the collectibility of specific accounts. The Company evaluates the collectibility of accounts receivable based on a combination of factors. Initially, the Company estimates an allowance for doubtful accounts as a percentage of accounts receivable based on historical collections experience. This initial estimate is periodically adjusted when the Company becomes aware of a specific customer s inability to meet its financial obligations (e.g., bankruptcy filing) or as a result of changes in the overall aging of accounts receivable. On October 1, 2004 the company implemented a policy to write-off all uncollectible accounts past due for more than a two-year period. As a result of the policy, $1,315,000 in fully reserved accounts receivable was written off against the allowance for doubtful accounts. During 2004, 2003, and 2002, the Company incurred bad debt expense related to trade receivables of $799,000, $843,000, and $2,117,000, respectively. The allowance for doubtful accounts amounted to $2,055,000 and $3,719,000 as of December 31, 2004 and 2003, respectively.

Inventories

Inventories consist primarily of merchandise purchased for resale and are stated at the lower of cost or market value. Cost is determined on a first-in first-out basis, and market is considered to be net realizable value. In determining the net realizable value, the Company identifies slow moving or obsolete inventories that are not eligible for return under various vendor return programs and estimates appropriate loss provisions related thereto. Management evaluates the adequacy of the loss provisions regularly, with any adjustments charged to cost of sales. We recorded inventory (recoveries) or expense for ($217,000), ($55,000), and $1,029,000, in 2004, 2003 and 2002, respectively. The reserve for obsolete and slow moving inventories was $5,168,000 and $5,597,000 as of December 31, 2004 and 2003, respectively.

Property and Equipment

Property and equipment are recorded at cost. Expenditures for repairs and maintenance are expensed as incurred. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized as other (income) expense in the statement of operations. Depreciation is computed using the straight-line method over the following estimated useful lives:

Buildings and improvements	40 years
Leasehold improvements	Lesser of useful life or the lease term
Furniture, fixtures, and equipment	5-10 years
Computer hardware and software	3-5 years

Goodwill and Other Intangible Assets

The Company adopted SFAS No. 142, Goodwill and Other Intangible Assets, on January 1, 2002. The Company tested goodwill for impairment using the two-step process prescribed in SFAS No. 142. The first step was a screen for potential impairment, while the second step measured the amount of the impairment, if any. Based on an independent appraisal firm s valuation of the enterprise fair value using a combination of discounted cash flows, market multiples, and comparable transactions, which reflect changes in certain assumptions since the date of the acquisitions, and the identification of qualifying intangibles, the Company recorded a non-cash charge of $50,347,000 as a cumulative effect of accounting change on January 1, 2002 associated with the adoption of SFAS No. 142.

The write-off of goodwill results from the use of a combination of fair value methods in assessment of fair value as required by SFAS No. 142. According to SFAS No. 142, the goodwill impairment loss is measured as the excess of the carrying amount of goodwill over the implied fair value of goodwill.

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At December 31, 2004 and 2003, accumulated amortization of intangible assets was $428,000 and $384,000, respectively. The aggregate estimated amortization expense related to other identifiable intangible assets for the years 2005 to 2009 is $213,000. The net carrying value of the intangible assets was $243,000 and $287,000 as of December 31, 2004 and 2003, respectively.

Long-Lived Assets

The Company assesses its long-lived assets for impairment whenever facts and circumstances indicate that the carrying amount may not be fully recoverable in accordance with SFAS No. 144, Accounting for the Impairment of Long-Lived Assets. To analyze recoverability, the Company projects undiscounted net future cash flows over the remaining life of such assets. If these projected cash flows were less than the carrying amount, impairment would be recognized, resulting in a write-down of assets with a corresponding charge to earnings. Impairment losses, if any, are measured based upon the difference between the carrying amount and the fair value of the assets. Management believes the long-lived assets in the accompanying consolidated balance sheets are fairly valued.

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes which requires that deferred tax assets and liabilities be recognized using currently enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. The Company currently has significant deferred tax assets, which are subject to periodic recoverability assessments. The realization of the Company s deferred tax assets is principally dependent upon the Company being able to generate sufficient future taxable income in certain tax jurisdictions. Factors used to assess the likelihood of realization are the Company s forecast of future taxable income (which is based upon estimates and assumptions) and available tax planning strategies that could be implemented to realize the net deferred tax assets. On the basis of the Company s operating results and projections for future taxable income, management believes it is more likely than not that future operations will generate sufficient taxable income to realize the deferred tax assets. During 2004, the Company determined that it is more likely than not that future tax benefits associated with certain state tax net operating loss carryforwards and deductible goodwill amortization for tax purposes will be realizable. The deferred tax assets associated with certain state net operating loss carryforwards and future goodwill amortization had been fully reserved with a valuation allowance primarily due to the assets extended reversal period and the uncertainty of future taxable income over this period. The Company made the determination to reverse the valuation allowance primarily based on our current taxable income and projections of future taxable income over the reversal period. This resulted in a $2,595,000 ($0.27 per diluted share for the year) reduction of the valuation allowance and an associated reduction of the provision for income tax expense. The valuation allowance for net deferred tax assets was $561,000 and $3,156,000 as of December 31, 2004 and 2003, respectively. The valuation allowance for deferred tax assets at December 31, 2004 is primarily for state net operating loss carryforwards for which the Company believes sufficient taxable income will not be realized prior to expiration.

Deferred Loan Costs

The Company capitalizes incremental and direct costs associated with the issuance of debt. These costs include legal fees, due diligence fees, and similar items. Deferred loan costs are amortized over the life of the related debt instrument and are classified as a non-current asset on the accompanying consolidated balance sheets. Amortization expense related to deferred loan costs for the years ended December 31, 2004, 2003, and 2002 was $240,000, $288,000, and $360,000, respectively. Such amortization is classified as interest expense in the accompanying statements of operations. As of December 31, 2004 and 2003, the net book value of the Company s deferred loan costs was $340,000, and $579,000, respectively.

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Revenue Recognition

Revenue is recognized on sales of products at the time title and risk of loss pass to the buyer. Title and risk of loss pass to the buyer in three ways. In the majority of circumstances, title and risk of loss pass to the buyer at the time of shipment. In other circumstances, such as consignment inventory agreements, title and risk of loss pass to the buyer at time of requisition of the good for use. For goods that are shipped direct from the supplier, title and risk pass to the buyer based on the suppliers shipping terms.

Volume Rebates

In circumstances where the Company offers volume rebates to customers, those volume rebates are estimated at the time of sale and netted against revenues earned. Volume rebates received from vendors are recorded as a reduction of cost of sales at the time the rebate is estimated to be earned and appropriate provisions are made in the pricing of inventory to account for the reduction in cost.

Shipping and Handling Costs

The Company s freight-in is recorded in cost of sales and freight-out is included in selling, general, and administrative expenses. Freight-out totaled $5,067,000, $4,425,000, and $4,421,000, for the years ended December 31, 2004, 2003, and 2002, respectively.

Financial Instruments

The Company s carrying value of financial instruments approximates fair value due to the short maturity of those instruments (cash, trade receivables, accounts payable, and accrued liabilities), or, in the case of debt, due to the instrument having a variable interest rate. Credit risk on trade receivables is minimized by the large and diverse nature of the Company s customer base. No one customer represented more than 5% of the Company s accounts receivable or sales for the periods presented. The Company s international sales represent less than 1% of sales for the periods presented.

Insurance Reserves

The Company is self-insured for certain losses relating to group health, worker s compensation, and casualty losses, subject to specific aggregate stop loss limits. Third-party administrators are used to process and administer all related claims. The Company accrues an estimate for insurance expense on a monthly basis based upon the claim estimates. The Company s insurance liability for incurred but not reported or unpaid claims is estimated based on the Company s historical actual claims experience rate.

Stock-Based Compensation

The Company has stock-based employee compensation plans, described more fully in Note 8. Prior to 2003, the Company accounted for these plans under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost was reflected in 2002 net earnings, as all options granted under those plans had an intrinsic value of zero on the date of grant. Effective January 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Under the prospective method of adoption selected by the Company under the provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the recognition provisions has been applied to all employee awards granted, modified, or settled after January 1, 2003.

The expense related to stock-based compensation included in the determination of net earnings for 2004 will be less than that which would have been recognized if the fair value method had been applied to all awards granted after the original effective date of SFAS No. 123. If the Company had elected to adopt the fair value of

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recognition provisions of SFAS No. 123 as of its original effective date, pro forma net earnings and diluted net earnings per share would be as follows (in thousands, except per share data):

	2004	2003 *(As Restated-See Note 1)*	2002
Net earnings (loss) as reported	$ 7,314	$ 2,361	$ (48,749)
Add: Total stock-based compensation expense included in the determination of net earnings as reported, net of tax	208	88	25
Deduct: Total stock-based compensation expense determined under fair-value based method for all awards, net of tax	429	413	380
Pro forma net earnings (loss)	$ 7,093	$ 2,036	$ (49,104)
Basic earnings (loss) per common share:			
As reported	$ 0.78	$ 0.26	$ (5.53)
Pro forma	$ 0.76	$ 0.23	$ (5.56)
Diluted earnings (loss) per common share:			
As reported	$ 0.75	$ 0.26	$ (5.44)
Pro forma	$ 0.73	$ 0.22	$ (5.54)

Segments

SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, requires that an enterprise disclose certain information about operating segments. The Company considers its entire business as one operating segment for purposes of SFAS No. 131.

New Accounting Pronouncements

The Company adopted the fair-value-based method of accounting for share-based payments effective January 1, 2003 using the prospective method described in SFAS No. 148. Currently, the Company uses the Black-Scholes-Merton formula to estimate the value of stock options granted to employees and expects to continue to use this acceptable option valuation model upon the required adoption Statement 123(R) on July 1, 2005. Because Statement 123(R) must be applied not only to new awards but to previously granted awards that are not fully vested on the effective date, and because the Company adopted Statement 123 using the prospective transition method (which applied only to awards granted, modified or settled after the adoption date), compensation cost for some previously granted awards that were not recognized under Statement 123 will be recognized under Statement 123(R). However, had we adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net earnings (loss) per common share in Note 2 to the Company s consolidating financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized for such excess tax deductions were $225,000, $180,000, and $0 in 2004, 2003, and 2002, respectively.

In January 2003, the FASB issued Interpretation 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. In December 2003, the FASB issued a revised Interpretation of FIN 46 (Revised Interpretation). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of the Revised Interpretation must be applied for the Company s first interim period ending after March 15, 2004. The Company s adoption of FIN 46 had no impact on the Company s financial position or consolidated statements of operations as a result of the adoption. The Company currently does not have relationships that require consolidation or disclosure about variable interest entities.

3. DIVESTITURES

During 2000, the Company divested of an operating subsidiary for a total consideration of $1,580,000 in the form of a note receivable. During 2002, the purchaser defaulted on the note. In 2004, the Company recovered collateral with a value of approximately $150,000 from the purchaser. In addition, in 2004, the Company assigned the remainder of the note to a third party in return for a note receivable in the amount of $1,000,000, before discounting. The Company received a payment in the amount of $300,000 in 2004 and of the remaining $700,000 of the note receivable, $450,000 is classified as an other current asset and $250,000 is classified as an other asset on the accompanying balance sheet as of December 31, 2004 at fair value. In 2004, the Company wrote off the uncollectible portion of the original note receivable of approximately $430,000 against reserves established in prior years.

4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31, 2004 and 2003 (in thousands):

	2004	**2003** ***(As Restated-See Note 1)***
Land, building, and improvements	$ 4,639	$ 3,872
Leasehold improvements	2,733	2,445
Furniture, fixtures, and equipment	6,974	7,467
Computer hardware and software	3,899	3,993
Total property and equipment	18,245	17,777
Less accumulated depreciation	(10,968)	(10,616)
Property and equipment, net	$ 7,277	$ 7,161

Depreciation expense totaled $865,000, $1,957,000 (As Restated -See Note 1), and $2,385,000 for the years ended December 31, 2004, 2003, and 2002, respectively.

5. SALE OF PROPERTY

During 2003, the Company sold properties located in Bridgeport, Connecticut, Tucker, Georgia, and Tacoma, Washington, in a continued effort to consolidate warehouse facilities and reduce assets. Collectively, these properties sold for $3,019,000, net of closing costs. Costs associated with these closings were expensed as incurred. The cumulative gain of $568,000 and associated relocation and severance costs of $353,000 related to these transactions are reported in selling, general, and administrative expenses in the December 31, 2003 consolidated statement of operations.

6. LONG-TERM DEBT

At December 31, 2004 and 2003, long-term debt consisted of the following (in thousands):

	2004	**2003**
Revolving credit facility (Note 7)	$ 21,700	$ 25,850
Other	581	683
Total debt	22,281	26,533
Less current portion	(196)	(185)
Total long-term debt	$ 22,085	$ 26,348

Maturities of long-term debt as of December 31, 2004 are as follows (in thousands):

2005	$ 196
2006	21,784
2007	60
2008	52
2009	38
Thereafter	151
	$ 22,281

For the years ended December 31, 2004, 2003, and 2002, the Company incurred interest expense of $1,630,000, $2,278,000, and $3,270,000, respectively.

7. REVOLVING CREDIT FACILITY

In December 2000, the Company entered into a $100,000,000 revolving credit facility with a five financial institution syndicate. On May 28, 2004, the Company amended this agreement to extend it to May 28, 2006. The agreement contains a first security interest in the assets of the Company. The agreement provides that the facility may be used for operations and acquisitions, and provides $5,000,000 for swinglines and $10,000,000 for letters of credit. Amounts outstanding under the credit facility bear interest at either the lead bank s corporate rate or LIBOR, as selected by the Company from time to time, plus applicable margins. This rate was 4.7% and 3.8% at December 31, 2004 and 2003, respectively. There is an annual commitment fee on the unused portion of the facility equal to between 25 and 37.5 basis points of the average daily unused portion of the aggregate commitment depending on the indebtedness to adjusted EBITDA ratio, as defined.

Commitment fees totaled $173,000 and $227,000 in 2004 and 2003, respectively. The amounts outstanding under the facility at December 31, 2004 and 2003 were $21,700,000 and $25,850,000, respectively, which have been classified as long-term liabilities in the consolidated balance sheets. Additionally, the Company had outstanding letters of credit of $2,050,000 and $2,199,000 under the facility at December 31, 2004 and 2003, respectively. The revolving credit facility contains various covenants pertaining to the maintenance of certain financial ratios. These covenants include requirements for interest coverage, net worth, and capital expenditures, among other restrictions. The covenants also prohibit the payment of cash dividends. The Company was in compliance with these covenants as of December 31, 2004 and 2003.

8. CAPITAL STOCK

Preferred Stock

Pursuant to the Company s certificate of incorporation, the board of directors, from time to time, may authorize the issuance of shares of preferred stock in one or more series, may establish the number of shares to be included in any such series, and may fix the designations, powers, preferences, and rights (including voting rights) of the shares of each such series and any qualifications, limitations, or restrictions thereon. No stockholder authorization is required for the issuance of shares of preferred stock unless imposed by then-applicable law. Shares of preferred stock may be issued for any general corporate purpose, including acquisitions. The board of directors may issue one or more series of preferred stock with rights more favorable with regard to dividends and liquidation than the rights of holders of common stock.

In August 2000, the Board of Directors designated 1,000,000 shares of the Company s previously authorized 10,000,000 shares of preferred stock as Series A Participating Cumulative Preferred Stock, as required for the Stockholder Rights Plan. There was no preferred stock issued or outstanding at December 31, 2004 and 2003.

Stockholder Rights Plan

In August 2000, the Company adopted a stockholder rights plan. The plan entailed a dividend on August 30, 2000 of one right for each outstanding share of the Company s common stock. Each right entitles the holder to buy one one-hundredth of a share of the new Series A Participating Cumulative Preferred Stock at an exercise price of $12.00 per right, or, in certain circumstances, to acquire common stock of an acquirer. Each one one-hundredth of a share of such preferred stock would be essentially the economic equivalent of a share of the Company s common stock. The rights will trade with the Company s common stock until exercisable. The rights will not be exercisable until ten calendar days following a public announcement that a person or group has acquired 20% of the Company s common stock, or, if any person or group has acquired such an interest, the acquisition by that person or group of an additional 2% of the Company s common stock. The Company will generally be entitled to redeem the rights at $.001 per right at any time until the date of public announcement that shares resulting in a 20% stock position have been acquired, and in certain other circumstances. The rights have no voting power, and until exercised, no dilutive effect on net earnings per common share.

Common Stock

Options are included in the computation of diluted earnings per share (EPS) where the options exercise price is less than the average market price of the common shares during the period. Common equivalent shares from stock options and restricted stock awards during the years ended December 31, 2004, 2003, and 2002 had a dilutive effect of 364,967, 149,227, and 138,021 shares, respectively, to the weighted average common shares outstanding using the treasury stock method. During 2004, 2003, and 2002, options where the exercise price exceeded the average market price of the common shares totaled 57,295, 376,861, and 812,932, respectively. The options expire ten years from the date of grant and vest ratably over three-to-four year periods. At December 31, 2004, the Company has several stock-based compensation plans, which are described below.

The total fair value of options granted in 2004, 2003, and 2002 was $181,000, $43,000, and $589,000, respectively. The weighted average fair value of the options on the date of grant in 2004, 2003, and 2002 was $3.61, $1.87, and $1.90, respectively.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions:

	2004	2003	2002
Expected life (years)	7	7	7
Dividend yield	0%	0%	0%
Expected stock price volatility	56%	58%	59%
Risk-free interest rate (low-high)	3.17% - 4.51%	3.62%	3.40% - 4.90%

The Black-Scholes-Merton option-pricing model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Stock Incentive Plan

In July 1997, the Company adopted its stock incentive plan to provide key employees, officers, and directors an opportunity to own common stock of the Company and to provide incentives for such persons to promote the financial success of the Company. Awards under the stock incentive plan may be structured in a variety of ways, including incentive and nonqualified stock options, shares of common stock subject to terms and conditions set by the board of directors (restricted stock awards), and stock appreciation rights (SARs). Incentive stock options may be granted only to full-time employees (including officers) of the Company and any subsidiaries. Nonqualified options, restricted stock awards, SARs, and other permitted forms of awards may be granted to any person employed by or performing services for the Company, including directors. The stock incentive plan provides for the issuance of an aggregate number of shares of common stock equal to 15% of the Company s diluted shares of common stock outstanding from time to time, subject to the issuance of a maximum of 1,000,000 shares pursuant to incentive stock options. The Company currently has 254,081 shares available for issue under the stock incentive plan.

Incentive stock options are subject to certain limitations prescribed by the Internal Revenue Code and generally may not be exercised more than ten years from the stated grant date. The board of directors of the Company (or a committee designated by the board) generally has discretion to set the terms and conditions of options and other awards, including the term, exercise price, and vesting conditions, if any; to select the persons who receive such grants and awards; and to interpret and administer the stock incentive plan.

A summary of the status of the stock incentive plan as of December 31, 2004, 2003, and 2002 and changes during the years then ended is presented in the table below:

	2004		2003		2002	
	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE
Facility; therefore, they are reported in the same period that the Credit Facility expires. The letters of credit that support construction contracts will expire when the related work is complete and the warranty period has passed; therefore, these letters of credit are reported in the period that we expect the warranty period to end.						

Contractual obligations at May 31, 2009 are summarized below:

	Contractual Obligations by Expiration Period				
	Less than 1 Year	1 3 Years	3 5 Years	More than 5 Years	Total
			(In thousands)		
Operating leases	$ 2,938	$ 5,185	$ 3,768	$ 1,888	$ 13,779
Capital lease obligations	1,049	936	1		1,986
Total contractual obligations	$ 3,987	$ 6,121	$ 3,769	$ 1,888	$ 15,765

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our interest rate risk results primarily from our variable rate indebtedness under our senior credit facility, which is influenced by movements in short-term rates. Borrowings under our $75.0 million revolving credit facility are based on an alternate base rate or one, two, three or six month LIBOR as elected by the Company plus an additional margin based on our Senior Leverage Ratio. Although there were no amounts outstanding under the facility at May 31, 2009 and we did not borrow under the facility in fiscal 2009, we have in the past and may in the future borrow against our revolving credit line to fund short-term working capital needs. We do not currently utilize interest rate swaps to hedge our interest rate risk; therefore, short-term interest rates could have an impact on future interest expense.

Financial instruments with interest rate risk at May 31, 2009 were as follows:

	Maturity by Fiscal Year						Fair Value as of May 31, 2009
	2010	2011	2012	2013	2014	Total	
	(In thousands)						
Long-term debt:							
Variable rate debt (1)	$	$	$	$	$	$	$

(1) There were no outstanding borrowings under our senior credit facility at May 31, 2009 nor were any amounts borrowed in fiscal 2009. 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, the Federal Funds Effective Rate plus 0.5% or LIBOR plus 1.00%. The additional margin ranges from 1.00% to 1.75% on Alternate Base Rate borrowings and from 2.00% to 2.75% on LIBOR-based borrowings. The Senior Leverage Ratio for the year ended May 31, 2009 placed the Company in the lowest interest rate tier, resulting in LIBOR and Alternate Base Rate margins of 2.00% and 1.00%, respectively.

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Financial instruments with interest rate risk at May 31, 2008 were as follows:

	Maturity by Fiscal Year						Fair Value as of May 31, 2008
	2009	2010	2011	2012 (In thousands)	2013	Total	
Long-term debt:							
Variable rate debt (1)	$	$	$	$	$	$	$
Acquisition payable (2)	111					111	111

(1) There were no outstanding borrowings under our senior credit facility at May 31, 2008. In fiscal 2008, the weighted average interest rate on our borrowings under our senior credit facility was 7.7%. At the Company s option, amounts borrowed under the revolving credit facility bore 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 was the greater of the prime rate or the fed funds effective rate plus 0.50%. The additional margin ranged from 0.00% to 0.25% on Alternate Base Rate borrowings and from 1.00% to 1.75% on LIBOR-based borrowings. The Senior Leverage Ratio for the year ended May 31, 2008 placed the Company in the lowest interest rate tier, resulting in LIBOR and Alternative Base Rate margins of 1.00% and 0.00%, respectively.

(2) The payment included in the table represents the amount the Company was obligated to pay in the period indicated. The Acquisition payable was recorded at its present value of $0.1 million in the financial statements, and was paid to the seller after the final resolution of disputed sales and use tax obligations.

Foreign Currency Risk

Matrix Service has subsidiaries with operations in Canada with the Canadian dollar as their functional currency. Historically, movements in the foreign currency exchange rate have not significantly impacted results. However, growth in our Canadian operations and fluctuations in the Canadian dollar could impact the Company s financial results in the future. Management has not entered into derivative instruments to hedge foreign currency risk, but periodically evaluates the materiality of our foreign currency exposure. A 10% change in the Canadian dollar against the U. S. dollar would not have had a material impact on the financial results of the Company for the fiscal year ended May 31, 2009.

Commodity Risk

Steel plate and steel pipe are the primary raw materials used by the Company. Supplies of these materials are available throughout the United States and worldwide. We anticipate that adequate amounts of these materials will be available in the foreseeable future, however, the price, quantity, and delivery schedules of these materials could change rapidly due to various factors, including producer capacity, the level of foreign imports, worldwide demand, the imposition or removal of tariffs on imported steel and other market conditions. We mitigate these risks by including standard language in our contracts, which passes the risk of increases in steel prices or unavailability of steel to our customers.

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Item 8. Financial Statements and Supplementary Data

Financial Statements of the Company

Financial Statement Schedules

The financial statement schedule is filed as a part of this report under Schedule II Valuation and Qualifying Accounts for the three fiscal years ended May 31, 2009, 2008, and 2007 immediately following Quarterly Financial Data (Unaudited). All other schedules are omitted because they are not applicable or the required information is shown in the financial statements, or notes thereto, included herein.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Matrix Service Company (the Company) and its wholly-owned subsidiaries are responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of May 31, 2009. In making this assessment, the Company s management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework.*

Management s assessment included an evaluation of such elements as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, overall control environment and information systems control environment. Based on this assessment, the Company s management has concluded that the Company s internal control over financial reporting as of May 31, 2009 was effective.

Deloitte & Touche LLP, an independent registered public accounting firm, has issued an attestation report on the effectiveness of the Company s internal control over financial reporting as of May 31, 2009. Deloitte & Touche LLP s report on the Company s internal control over financial reporting is included herein.

/s/ Michael J. Bradley	/s/ Thomas E. Long
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Michael J. Bradley	**Thomas E. Long**
President and Chief Executive Officer	**Vice President and Chief Financial Officer**

August 4, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Matrix Service Company:

We have audited the internal control over financial reporting of Matrix Service Company and subsidiaries (the Company) as of May 31, 2009 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of May 31, 2009, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended May 31, 2009 of the Company and our report dated August 4, 2009 expressed an unqualified opinion on those financial statements and financial statement schedule.

/s/ Deloitte & Touche LLP

Tulsa, Oklahoma

August 4, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Matrix Service Company:

We have audited the accompanying consolidated balance sheets of Matrix Service Company and subsidiaries (the Company) as of May 31, 2009 and 2008, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2009. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and the financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Matrix Service Company and subsidiaries as of May 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended May 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of May 31, 2009, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 4, 2009 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

Tulsa, Oklahoma

August 4, 2009

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Matrix Service Company

Consolidated Balance Sheets

(In thousands)

	As of May 31, 2009	2008
Assets		
Current assets:		
Cash and cash equivalents	$ 34,553	$ 21,989
Accounts receivable, less allowances (2009 $710; 2008 $269)	122,283	105,858
Costs and estimated earnings in excess of billings on uncompleted contracts	35,619	49,940
Inventories	4,926	4,255
Income tax receivable	647	
Deferred income taxes	4,843	4,399
Prepaid expenses	3,935	3,357
Other current assets	3,044	809
Total current assets	209,850	190,607
Property, plant and equipment, at cost:		
Land and buildings	27,319	24,268
Construction equipment	53,925	47,370
Transportation equipment	17,971	16,927
Furniture and fixtures	14,527	11,781
Construction in progress	812	6,712
	114,554	107,058
Accumulated depreciation	(55,745)	(49,811)
	58,809	57,247
Goodwill	25,768	23,329
Other intangible assets	4,571	
Other assets	4,453	3,410
Total assets	$ 303,451	$ 274,593

See accompanying notes.

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Matrix Service Company

Consolidated Balance Sheets (continued)

(In thousands, except share data)

	As of May 31, 2009	As of May 31, 2008
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 48,668	$ 53,560
Billings on uncompleted contracts in excess of costs and estimated earnings	51,305	48,709
Accrued insurance	7,612	8,451
Accrued wages and benefits	16,566	14,976
Income tax payable		2,028
Current capital lease obligation	1,039	1,042
Other accrued expenses	2,200	1,015
Total current liabilities	127,390	129,781
Long-term capital lease obligation	850	1,000
Deferred income taxes	4,822	5,112
Stockholders equity:		
Common stock $.01 par value; 60,000,000 shares authorized; 27,888,217 shares issued as of May 31, 2009 and 2008	279	279
Additional paid-in capital	110,272	108,402
Retained earnings	75,393	44,809
Accumulated other comprehensive income	596	1,584
	186,540	155,074
Less treasury stock, at cost 1,696,517 and 1,825,600 shares as of May 31, 2009 and 2008	(16,151)	(16,374)
Total stockholders equity	170,389	138,700
Total liabilities and stockholders equity	$ 303,451	$ 274,593

See accompanying notes.

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Matrix Service Company

Consolidated Statements of Income

(In thousands, except per share data)

	Fiscal Year Ended May 31,		
	2009	**2008**	**2007**
Revenues	$ 689,720	$ 731,301	$ 639,846
Cost of revenues	595,397	656,184	573,960
Gross profit	94,323	75,117	65,886
Selling, general and administrative expenses	47,006	40,566	32,836
Operating income	47,317	34,551	33,050
Other income (expense):			
Interest expense	(563)	(890)	(2,403)
Interest income	330	82	139
Other	675	(27)	328
Income before income taxes	47,759	33,716	31,114
Provision for federal, state and foreign income taxes	17,170	12,302	11,943
Net income	$ 30,589	$ 21,414	$ 19,171
Basic earnings per common share	$ 1.17	$ 0.81	$ 0.83
Diluted earnings per common share	$ 1.16	$ 0.80	$ 0.74
Weighted average common shares outstanding:			
Basic	26,121	26,427	23,056
Diluted	26,390	26,875	26,752

See accompanying notes.

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Matrix Service Company

Consolidated Statements of Changes in Stockholders Equity

(In thousands, except share data)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Translation Adjustments	Total
Balances, May 31, 2006	$ 226	$ 75,855	$ 4,316	$ (4,812)	$ 814	$ 76,399
Net income			19,171			19,171
Other comprehensive income					153	153
Comprehensive income						19,324
Conversion of convertible notes (5,292,974 shares)	53	23,623				23,676
Exercise of stock options (433,920 shares)		1,324	(65)	1,312		2,571
Tax effect of exercised stock options		2,132				2,132
Stock-based compensation expense		1,474				1,474
Balances, May 31, 2007	279	104,408	23,422	(3,500)	967	125,576
Net income			21,414			21,414
Other comprehensive income					617	617
Comprehensive income						22,031
Exercise of stock options (165,450 shares)		574	(27)	494		1,041
Tax effect of exercised stock options		721				721
Stock-based compensation expense		2,874				2,874
Issuance of deferred shares (59,590 shares)		(175)		175		
Other treasury share purchases (23,192 shares)				(700)		(700)
Open market purchase of treasury shares (729,982 shares)				(12,843)		(12,843)
Balances, May 31, 2008	279	108,402	44,809	(16,374)	1,584	138,700
Net income			30,589			30,589
Other comprehensive loss					(988)	(988)
Comprehensive income						29,601
Exercise of stock options (62,950 shares)		108	(5)	169		272
Tax effect of exercised stock options and vesting of deferred shares		(220)				(220)
Stock-based compensation expense		2,206				2,206
Issuance of deferred shares (83,370 shares)		(224)		224		
Treasury share purchases (17,237 shares)				(170)		(170)
Balances, May 31, 2009	$ 279	$ 110,272	$ 75,393	$ (16,151)	$ 596	$ 170,389

See accompanying notes.

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Matrix Service Company

Consolidated Statements of Cash Flows

(In thousands)

	Fiscal Year Ended May 31,		
	2009	**2008**	**2007**
Operating activities:			
Net income	$ 30,589	$ 21,414	$ 19,171
Adjustments to reconcile net income to net cash provided by operating activities, net of effects of acquisitions:			
Depreciation and amortization	10,760	8,373	6,500
(Gain) loss on sale of property, plant and equipment	250	(6)	(186)
Allowance for uncollectible accounts	441	1,161	189
Stock-based compensation expense	2,206	2,874	1,474
Accretion on acquisition payable		108	206
Amortization of debt issuance costs	123	152	372
Amortization of prepaid interest			1,069
Inventory lower of cost or market write-down	1,157		
Deferred income tax	(88)	1,484	(1,442)
Tax benefit deficiency from vesting of deferred shares	(347)		
Changes in operating assets and liabilities increasing (decreasing) cash, net of effects from acquisitions (Note 2):			
Receivables	9,838	(2,748)	(22,957)
Costs and estimated earnings in excess of billings on uncompleted contracts	16,928	(4,306)	(21,096)
Inventories	(1,828)	636	(1,369)
Prepaid expenses and other assets	(749)	(1,530)	(3,879)
Accounts payable	(25,063)	963	5,590
Billings on uncompleted contracts in excess of costs and estimated earnings	(3,411)	14,466	22,166
Accrued expenses	494	1,265	4,333
Income tax receivable/payable	(2,676)	1,290	1,217
Net cash provided by operating activities	38,624	45,596	11,358
Investing activities:			
Acquisition of property, plant and equipment	(9,983)	(18,302)	(13,120)
Proceeds from asset sales	1,002	452	288
Acquisitions, net of cash acquired	(15,337)		
Net cash used by investing activities	$ (24,318)	$ (17,850)	$ (12,832)

See accompanying notes.

Matrix Service Company

Consolidated Statements of Cash Flows (continued)

(In thousands)

	Fiscal Year Ended May 31, 2009	2008	2007
Financing activities:			
Exercise of stock options	$ 272	$ 1,041	$ 2,571
Advances under bank credit facility		183,810	126,740
Repayments of bank credit facility		(183,810)	(126,740)
Payment of debt amendment fees	(244)		(145)
Capital lease payments	(1,137)	(775)	(671)
Repayment of other notes		(2,709)	(1,880)
Tax benefit of exercised stock options and vesting of deferred shares	127	721	2,132
Open market purchase of treasury shares		(12,843)	
Other treasury share purchases	(170)	(700)	
Net cash provided (used) by financing activities	(1,152)	(15,265)	2,007
Effect of exchange rate changes on cash	(590)	361	29
Net increase in cash and cash equivalents	12,564	12,842	562
Cash and cash equivalents, beginning of year	21,989	9,147	8,585
Cash and cash equivalents, end of year	$ 34,553	$ 21,989	$ 9,147
Supplemental disclosure of cash flow information			
Cash paid during the period for:			
Income taxes	$ 20,134	$ 8,750	$ 10,034
Interest	$ 396	$ 529	$ 723
Non-cash investing and financing activities:			
Equipment acquired through capital leases	$ 877	$ 1,220	$ 1,316
Purchases of property, plant and equipment on account	$ 49	$ 484	$ 142
Conversion of convertible notes	$	$	$ 25,000

See accompanying notes.

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Matrix Service Company

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Organization and 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 transactions and balances have been eliminated in consolidation.

The Company operates primarily in the United States and has operations in Canada. The Company s reportable segments are Construction Services and Repair and Maintenance Services.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue Recognition

Matrix Service records profits on fixed-price contracts on a percentage-of-completion basis, primarily based on costs incurred to date compared to the total estimated contract cost. Matrix Service records revenue on reimbursable and time and material contracts on a proportional performance basis as costs are incurred. 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 which 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 contracts 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 fixed-price 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, on a percentage-of-completion basis, when estimable and 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.

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

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

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.

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.

Cash Equivalents

The Company includes as cash equivalents all investments with original maturities of three months or less which are readily convertible into cash. The carrying value of cash equivalents approximates fair value. Approximately $0.3 million of cash as of May 31, 2009 and 2008 is classified as Other Assets as it is restricted for use under an alliance agreement with a customer.

Accounts Receivable

Accounts receivable are carried on a gross basis, less the allowance for uncollectible accounts. The Company s customers consist primarily of major integrated oil companies, independent refiners and marketers, power companies, petrochemical companies, pipelines, contractors and engineering firms. The Company is exposed to the risk of individual customer defaults or depressed cycles in our customers industries. To mitigate this risk many of our contracts require payment as projects progress or advance payment in some circumstances. In addition, in most cases the Company can place liens against the property, plant or equipment constructed or terminate the contract if a material contract default occurs. Management estimates the allowance for uncollectible accounts based on existing economic conditions, the financial condition of its customers and the amount and age of past due accounts. Accounts are written off against the allowance for uncollectible accounts only after all collection attempts have been exhausted.

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-by-case 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.

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Inventories

Inventories consist primarily of raw materials and are stated at the lower of cost or net realizable value. Cost is determined primarily using the average cost method. As a result of a decline in the market value of steel, which is a major component of the raw material cost, the Company recorded a charge of $1.2 million in fiscal 2009 as an increase to cost of revenues.

Depreciation

Depreciation is computed using the straight-line method over the estimated useful lives of the depreciable assets. Depreciable lives are as follows: buildings 40 years, construction equipment 3 to 15 years, transportation equipment 3 to 5 years, and furniture and fixtures 3 to 10 years.

Impairment of Long-Lived Assets

The Company evaluates long-lived assets, including intangibles, for impairment when events or changes in circumstances indicate, in management s judgment, that the carrying value of such assets used in operations may not be recoverable. The determination of whether an impairment has occurred is based on management s estimate of undiscounted future cash flows attributable to the assets as compared to the carrying value of the assets. If an impairment has occurred, the amount of the impairment recognized is determined by estimating the fair value for the assets and recording a loss provision if the carrying value is greater than fair value.

For assets identified to be disposed of in the future, the carrying value of the assets are compared to the estimated fair value less the cost of disposal to determine if an impairment is required. Until the assets are disposed of, an estimate of the fair value is redetermined when related events or circumstances change.

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 acquisition date fair value of the identifiable 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 result in the recognition of impairment charges in the financial statements. We utilize various 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.

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Other Intangible Assets

Intangible assets that have finite useful lives are amortized by the straight-line method over their useful lives. Intangible assets that have indefinite useful lives are not amortized but are tested at least annually for impairment. Each reporting period, we evaluate the remaining useful lives of intangible assets not being amortized to determine whether facts and circumstances continue to support an indefinite useful life. Intangible assets are considered impaired if the fair value of the intangible asset is less than its net book value. If quoted market prices are not available, the fair values of the intangible assets are determined based on present values of expected future cash flows using discount rates commensurate with the risks involved.

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 May 31, 2009 and 2008, insurance reserves totaling $7.6 million and $8.5 million, respectively, are included in our consolidated balance sheet. These amounts represent our best estimate of our ultimate obligations for asserted claims, insurance premium obligations and claims incurred but not yet reported at the balance sheet dates. We establish reserves for claims using a combination of actuarially determined estimates and case-by-case evaluations 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.

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.

Recently Issued Accounting Standards

Accounting standards that have recently been issued that may impact our Consolidated Financial Statements include the following.

SFAS No. 141(R) Business Combinations

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS No. 141(R)). SFAS No. 141(R) applies to all business combinations and establishes guidance for recognizing and measuring identifiable assets acquired, liabilities assumed, noncontrolling interests in the acquiree and goodwill. Most of these items are recognized at their full fair value on the acquisition date, including acquisitions where the acquirer obtains control but less than 100 percent ownership in the acquiree. SFAS No. 141(R) also requires transaction costs to be recognized as expense as incurred and establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective for business combinations with an acquisition date in fiscal years beginning after December 15, 2008 and will be evaluated and implemented in conjunction with any future acquisitions.

SFAS No. 157 Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). This Statement established a framework for fair value measurements in the financial statements by providing a definition of fair value, guidance on the methods used to estimate fair value and expanded disclosures about fair

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, and accordingly, does not require any new fair value measurements. SFAS No. 157 became effective for fiscal years beginning after November 15, 2007 and was applied prospectively. The adoption of SFAS No. 157 in fiscal 2009 did not have a material effect on our financial statements.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS No. 159), The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 . SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 159 in fiscal 2009 did not have a material effect on our financial statements.

SFAS No. 165 Subsequent Events

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165). The Statement s objective is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Entities are required to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected. SFAS No. 165 is effective for interim and annual periods ending after June 15, 2009.

Note 2. Acquisitions

Purchase of Engineering and Construction Assets and Technology

On December 20, 2008, the Company acquired engineering and construction resources and technology used to design, engineer and construct single and full containment LNG storage tanks, LIN/LOX storage tanks, LPG storage tanks and thermal vacuum chambers from CB&I Inc., a subsidiary of Chicago Bridge & Iron Company N.V. (CB&I). The purchase included approximately 70 engineering and construction personnel, along with tools, equipment, and a perpetual license to use CB&I s technology necessary to design, engineer and construct LNG storage tanks, LIN/LOX storage tanks, LPG storage tanks and thermal vacuum chambers.

Purchase of S.M. Electric Company, Inc.

On February 5, 2009 the Company acquired S.M. Electric Company, Inc. (SME). The purchase price consisted primarily of the repayment of SME s bank indebtedness and the repayment of certain indebtedness to SME s former owners. SME, located in Rahway, New Jersey, provides electrical and contracting services to industrial and utility customers in the Northeastern United States. SME has contracts and performs work in both the Repair and Maintenance and Construction Services segments. SME s financial results are included in both operating segments from February 5, 2009.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

The purchase prices were allocated to the major categories of assets and liabilities based upon their estimated fair values at their respective acquisition dates. The Company is still evaluating certain SME projects that were in progress at the acquisition date; therefore, the purchase price allocation will not be finalized until these projects progress to a point that allows us to complete our evaluations. The following table summarizes the preliminary purchase price allocation as of May 31, 2009.

Current assets	$ 33,214
Property, plant and equipment	2,281
Tax deductible goodwill	3,325
Other intangible assets	4,721
Other non-current assets	541
Total assets acquired	44,082
Current liabilities	28,612
Non-current liabilities	75
Net assets acquired	15,395
Cash acquired	58
Net purchase price	$ 15,337

The operating and proforma data related to the SME acquisition was not material. Both acquisitions were funded with cash on hand.

Acquisition Payable

In fiscal years 2009, 2008 and 2007 Matrix Service paid $0.1 million, $2.7 million and $1.9 million, respectively, to the former shareholders of a company acquired in fiscal 2003. As of May 31, 2009, Matrix Service has no additional obligations related to this acquisition.

Note 3. Customer Contracts

Contract terms of the Company s construction contracts generally provide for progress billings based on project milestones. The excess of costs incurred and estimated earnings over amounts billed on uncompleted contracts is reported as a current asset. The excess of amounts billed over costs incurred and estimated earnings on uncompleted contracts is reported as a current liability. Gross and net amounts on uncompleted contracts are as follows:

	As of May 31, 2009	As of May 31, 2008
	(In thousands)	
Costs incurred and estimated earnings recognized on uncompleted contracts	$ 1,071,904	$ 982,369
Billings on uncompleted contracts	1,087,590	981,138
	$ (15,686)	$ 1,231
Shown on balance sheet as:		
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 35,619	$ 49,940

Billings on uncompleted contracts in excess of costs and estimated earnings	51,305	48,709
	$ (15,686)	$ 1,231

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Accounts receivable at May 31, 2009 and 2008 included retentions to be collected within one year of $15.2 million and $16.3 million, respectively. Contract retentions collectible beyond one year are included in Other Assets on the Consolidated Balance Sheets and totaled $2.8 million at May 31, 2009 and $1.7 million at May 31, 2008.

Gulf Coast LNG Project

The Company completed the construction of three LNG tanks in the Gulf Coast in fiscal 2008. The project resulted in a cumulative net loss of $29.8 million of which $20.8 million in losses was included in fiscal 2008 earnings and $11.4 million of losses was included in fiscal 2007 results. All retentions on this project have been billed and collected.

Note 4. Goodwill and Other Intangible Assets

Goodwill

The changes in the carrying amount of goodwill by segment for the fiscal years ended May 31, 2009 and 2008 are as follows:

	Construction Services	Repair and Maintenance Services	Total
		(In thousands)	
Balance at May 31, 2007	$ 4,205	$ 19,152	$ 23,357
Purchase price adjustment	(153)	(65)	(218)
Translation adjustment		190	190
Balance at May 31, 2008	4,052	19,277	23,329
Purchase price adjustment	(452)	(194)	(646)
Translation adjustment		(240)	(240)
Acquisition of business (Note 2)	1,995	1,330	3,325
Balance at May 31, 2009	$ 5,595	$ 20,173	$ 25,768

The translation adjustment relates to goodwill recorded as a part of a Canadian acquisition. A deferred tax asset valuation allowance relating to an acquisition was reversed that resulted in the goodwill adjustments in both fiscal 2009 and 2008.

Other Intangible Assets

Information on the carrying value of other intangible assets for the fiscal year ended May 31, 2009 is as follows:

	Useful Life (years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
			(In thousands)	
Intellectual property	6 to 12	$ 2,460	$ (70)	$ 2,390
Customer based	1 to 15	769	(74)	695
Other	3	42	(6)	36

Total amortizing intangibles		3,271		(150)		3,121
Trade name	Indefinite	1,450				1,450
Total Intangible Assets		$ 4,721	$	(150)	$	4,571

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Amortization expense totaled $0.2 million in fiscal 2009. Amortization expense is expected to be $0.4 million in fiscal 2010 and $0.2 million annually in fiscal 2011 to 2014.

Note 5. Debt

The Company has a five-year, $75.0 million senior revolving credit facility (Credit Facility) that expires on November 30, 2012. The Credit Facility is guaranteed by substantially all of the Company s subsidiaries and is secured by a lien on substantially all of the Company s assets.

Availability under the senior credit facility is as follows:

	May 31, 2009	May 31, 2008
	(In thousands)	
Senior credit facility revolver	$ 75,000	$ 75,000
Letters of credit	7,263	4,648
Availability under senior credit facility	$ 67,737	$ 70,352

The Credit Facility may be used for working capital, issuance of letters of credit or other lawful corporate purposes. The Credit Agreement contains customary affirmative and negative covenants that place certain restrictions on the Company, including limits on new debt, operating and capital lease obligations, asset sales and certain distributions, including dividends.

On February 11, 2009, the Company entered into an amendment (Amendment) to the Credit Facility which altered certain key provisions of the Credit Facility including the following:

The limitation on share repurchases was increased from $25.0 million for the life of the Credit Facility, to $25.0 million in any calendar year.

The prior limitation on acquisitions of $7.5 million in any consecutive twelve month period and $20.0 million for the life of the Credit Facility was eliminated so long as the Company s Senior Leverage Ratio on a pro forma basis as of the end of the fiscal quarter immediately preceding the acquisition is below 1.00 to 1.00 and availability under the Credit Facility is at or above 50% after consummation of the acquisition. If the Senior Leverage Ratio on a pro forma basis as of the end of the fiscal quarter immediately preceding the acquisition is over 1.00 to 1.00 but below 1.75 to 1.00, acquisitions will be limited to $25.0 million in a twelve month period, provided there is at least $25.0 million of availability under the Credit Facility after the consummation of the acquisition.

A financial covenant was modified to require that we maintain a Tangible Net Worth in an amount which is no less than the sum of $110.0 million, plus the net proceeds of any issuance of equity that occurs after November 30, 2008, plus 50% of all positive quarterly net income after November 30, 2008. Previously, we were required to maintain a Tangible Net Worth of no less than the sum of $55.6 million, plus the net cash proceeds of any issuance of equity that occurred after August 31, 2006, plus 75% of all positive quarterly net income after August 31, 2006.

Amounts borrowed under the Credit Facility will continue to bear interest at LIBOR or an Alternate Base Rate, plus in each case, an additional margin based on the Senior Leverage Ratio.

The additional margins on the LIBOR-based loans increased from between 1.00% and 1.75% to between 2.00% and 2.75% based on the Senior Leverage Ratio.

The additional margins on the Alternate Base Rate loans increased from between 0.00% and 0.25% to between 1.00% and 1.75% based on the Senior Leverage Ratio.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

The Alternate Base Rate is now the greater of the Prime Rate, Federal Funds Effective Rate plus 0.50% or LIBOR plus 1.00%. Previously, the Alternate Base Rate was the greater of the Prime Rate or the Federal Funds Effective Rate plus 0.50%.

The Unused Revolving Credit Facility Fee increased from between 0.175% and 0.375% to between 0.35% and 0.50% based on the Senior Leverage Ratio.

Other significant financial covenants that were not changed by the Amendment include the following:

Senior Leverage Ratio not to exceed 2.50 to 1.00;

Asset Coverage Ratio to be greater than or equal to 1.45 to 1.00; and,

Fixed Charge Coverage Ratio to be greater than or equal to 1.25 to 1.00.

The Company is currently in compliance with all affirmative, negative, and financial covenants under the Credit Facility and is at the lowest margin tier for the LIBOR and Alternate Base Rate loans and the lowest tier for the Unused Revolving Credit Facility Fee. However, non-compliance with any of these ratios or a violation of other covenants could result in an event of default and reduce availability under the facility.

Convertible Notes

Convertible notes with a principal balance of $30.0 million, were issued through a private placement transaction on April 25, 2005. The notes were convertible into shares of our Common Stock at a conversion price of $4.69 per share. In fiscal 2006, $5.0 million of the convertible notes were converted into 1,002,275 shares of our Common Stock. The remaining $25.0 million of notes were converted into 5,292,974 shares of our Common Stock in fiscal 2007.

Note 6. Income Taxes

The components of the provision for income taxes are as follows:

	Fiscal Year Ended May 31,		
	2009	**2008**	**2007**
		(In thousands)	
Current:			
Federal	$ 14,485	$ 9,213	$ 11,321
State	2,023	1,280	1,786
Foreign	750	325	278
	17,258	10,818	13,385
Deferred:			
Federal	484	1,550	(1,007)
State	(555)	(58)	(434)
Foreign	(17)	(8)	(1)

	(88)	1,484	(1,442)
	$ 17,170	$ 12,302	$ 11,943

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

The difference between the expected income tax provision applying the domestic federal statutory tax rate and the reported income tax provision is as follows:

	Fiscal Year Ended May 31, 2009	2008	2007
		(In thousands)	
Expected provision for Federal income taxes at the statutory rate	$ 16,716	$ 11,801	$ 10,890
State income taxes, net of Federal benefit	1,699	1,206	1,120
Charges without tax benefit	(230)	(26)	529
Change in valuation allowance	(957)	2	(764)
State investment credits	(48)	(538)	
Other	(10)	(143)	168
Provision for income taxes	$ 17,170	$ 12,302	$ 11,943

The change in the valuation allowance reduced the income tax provision by $1.0 million in fiscal 2009 and $0.8 million in fiscal 2007. The valuation allowance did not impact the fiscal 2008 provision. The valuation allowance change also resulted in a reduction to goodwill of $0.6 million, $0.2 million and $0.2 million in fiscal 2009, 2008 and 2007, respectively.

Significant components of the Company s deferred tax liabilities and assets as of May 31, 2009 and 2008 were as follows:

	As of May 31, 2009	2008
	(In thousands)	
Deferred tax liabilities:		
Tax over book depreciation	$ 7,302	$ 5,072
Change in tax accounting methods	346	761
Other net	540	480
Total deferred tax liabilities	8,188	6,313
Deferred tax assets:		
Bad debt reserve	436	105
Foreign insurance dividend	132	132
Vacation accrual	375	354
Insurance reserve	2,439	2,750
Noncompete amortization	45	62
Net operating loss benefit and credit carryforwards	3,497	3,002
Valuation allowance	(774)	(2,377)
Accrued compensation and pension	397	550
Stock compensation expense on nonvested deferred shares	1,061	806
Accrued losses	379	166
Other net	222	50
Total deferred tax assets	8,209	5,600
Net deferred tax asset (liability)	$ 21	$ (713)

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

As reported in the consolidated balance sheets:

	As of May 31, 2009	2008
	(In thousands)	
Current deferred tax assets	$ 4,843	$ 4,399
Non-current deferred tax liabilities	(4,822)	(5,112)
Net deferred tax asset (liability)	$ 21	$ (713)

The Company has state operating loss carryforwards, state investment tax credit carryforwards and federal foreign tax credit carryforwards of which a portion relates to an acquisition. The valuation allowance at May 31, 2009 and May 31, 2008 reduces the recognized tax benefit of these carryforwards to an amount that will more likely than not be realized. The carryforwards generally expire between 2017 and 2027.

Note 7. Contingencies

Insurance Reserves

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

Typically our contracts require us to indemnify our 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, or we may have to purchase special insurance policies or surety bonds for specific customers or provide letters of credit issued under our credit facility in lieu of bonds to satisfy performance and financial guarantees on some projects. Matrix Service maintains a performance and payment bonding line sufficient to support the business. The Company generally requires its subcontractors to indemnify the Company and the Company s customer and name the Company as an additional insured for activities arising out of the subcontractors presence at the customer s location. We also require certain subcontractors to provide additional insurance policies, including surety bonds in favor of the Company, to secure the subcontractors work or as required by the subcontract.

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

Material Legal Proceeding

On November 6, 2005, two employees of the Company s subsidiary Matrix Service Industrial Contractors, Inc. (MSICI), were fatally injured in an accident that occurred at a refinery in Delaware City, Delaware. The estates of both employees have sued the refinery owner for an unspecified amount of damages, including punitive damages. On January 10, 2007 the refinery owner filed a complaint in the Superior Court of the State of Delaware, New Castle County, against the Company and MSICI seeking status as an additional insured under the Company s insurance policy and for indemnification for any amounts which it may be required to pay to the estates of the deceased.

The estate of one of the deceased has settled its claim with the refinery owner, and the Company s insurer paid a portion of the settlement on the refinery owner s behalf as an additional insured. The refinery owner is pursuing its claim against the Company for the remainder of the settlement and for any liability which it may have to the other estate. A trial involving the claim of the other estate against the refinery owner is expected to

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

begin in the third or fourth calendar quarter of 2009. The Company believes that any amounts which it may be required to pay the refinery owner beyond what it has previously reserved will be covered by its insurance policy.

Unapproved Change Orders and Claims

As of May 31, 2009 and May 31, 2008, costs and estimated earnings in excess of billings on uncompleted contracts included revenues for unapproved change orders of $ 0.5 million and $0.8 million, respectively. There were no claims included in costs and estimated earnings in excess of billings on uncompleted contracts at May 31, 2009 or May 31, 2008. Generally, collection of amounts related to unapproved change orders and claims is expected within twelve months. However, customers generally will not pay these amounts 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 each of them. It is the opinion of management that none of the known legal actions will have a material adverse impact on the Company s financial position, results of operations or liquidity.

Note 8. Leases

Operating Leases

The Company is the lessee under operating leases covering real estate, office equipment and vehicles under non-cancelable operating lease agreements that expire at various times. Future minimum lease payments under non-cancelable operating leases that were in effect at May 31, 2009 total $13.8 million and are payable as follows: fiscal 2010 $2.9 million; fiscal 2011 $2.8 million; fiscal 2012 $2.4 million; fiscal 2013 $2.2 million; fiscal 2014 $1.6 million and thereafter $1.9 million. Operating lease expense was $2.7 million, $1.9 million and $1.2 million for the years ended May 31, 2009, 2008 and 2007, respectively.

Capital Leases

The Company leases most of its copiers, printers, and passenger vehicles under various non-cancelable lease agreements. Minimum lease payments have been capitalized and the related assets and obligations recorded using various interest rates. The assets are depreciated on a straight line method over their estimated useful lives. Interest expense is recognized using the effective interest method.

The following table is a summary of future obligations under capital leases:

	Minimum Lease Payments (In thousands)	
For the year ending May 31:		
2010	$	1,049
2011		717
2012		219
2013		1
2014 and thereafter		
Total Payments		1,986
Amount representing interest		97

Total obligation		1,889
Current portion		1,039
Long-term capital lease obligation	$	850

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Assets with a cost of $4.6 million and $3.9 million have been capitalized under capital lease arrangements at May 31, 2009 and 2008. The net book value of these assets was $2.1 million at both dates.

Note 9. Stockholders Equity

Preferred Stock

The Company has 5.0 million shares of preferred stock authorized, none of which was issued or outstanding at May 31, 2009 or 2008.

Preferred Share Purchase Rights

The Company s Board of Directors authorized and directed a dividend of one preferred share purchase right for each common share outstanding on November 12, 1999 and authorized and directed the issuance of one right per common share for any shares issued after that date. These rights, which expire November 12, 2009, will be exercisable only if a person or group acquires 15 percent or more of the Company s common stock or announces a tender offer that would result in ownership of 15 percent or more of the common stock. Each right will entitle stockholders to buy one one-hundredth of a share of preferred stock at an exercise price of $40. In addition, the rights enable holders to either acquire additional shares of the Company s common stock or purchase the stock of an acquiring company at a discount, depending on specific circumstances. The rights may be redeemed by the Company in whole, but not in part, for one cent per right.

In connection with the issuance of the convertible notes described under Note 5. Debt and the private placement of common stock on October 3, 2005, the Company amended the Rights Agreement for the preferred share purchase rights. The amendments render the provisions of the Rights Agreement inapplicable to the investors in the two private placements by exempting them from the definition of acquiring person as a result of the purchase of the convertible notes and common stock.

Treasury Shares

On February 4, 2009 our Board of Directors authorized a stock buyback program (February 2009 Program) that allows the Company to purchase up to 3,000,000 shares of Common Stock provided that such purchases do not exceed $25.0 million in any calendar year commencing in calendar year 2009 and continuing through calendar year 2012. The February 2009 Program replaced the previous stock buyback program that had been in effect since October 2000. The Company did not purchase any common shares under either program in fiscal 2009.

In addition to the stock buyback program, Matrix Service may withhold shares of common stock to satisfy the tax withholding obligation upon vesting of an employee s deferred shares. Any shares withheld are returned to treasury and are available for future issuance. The Company withheld 17,237 and 23,192 shares of common stock during fiscal 2009 and fiscal 2008 to satisfy these obligations.

Matrix Service will continue to repurchase shares in conjunction with the future issuance of deferred shares and may repurchase shares under the stock buyback program if sufficient liquidity exists and the Company believes that it is in the best interest of the shareholders. The Company has 1,696,517 treasury shares as of May 31, 2009 and intends to utilize these treasury shares solely in connection with equity awards under the Company s stock incentive plans.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Note 10. Stock-Based Compensation

Total stock-based compensation expense for the years ended May 31, 2009, 2008 and 2007 was $2.2 million, $2.9 million and $1.5 million, respectively. Measured but unrecognized stock-based compensation expense at May 31, 2009 was $4.6 million, of which $0.2 million related to stock options and $4.4 million related to nonvested deferred shares. These amounts are expected to be recognized as expense over a weighted average period of 2.1 years.

Plan Information

The Company s 1990 Incentive Stock Option Plan (the 1990 Plan), 1991 Incentive Stock Option Plan (the 1991 Plan), and 2004 Stock Incentive Plan (the 2004 Plan) provide incentives for officers and other key employees of the Company and the 1995 Nonemployee Directors Stock Option Plan (the 1995 Plan) provided incentives for nonemployee directors. Stockholders have authorized an aggregate of 1,800,000 options, 2,640,000 options, and 500,000 options to be granted under the 1990, 1991 and 1995 Plans, respectively. Grants of awards totaling 1,200,000 shares have been authorized by stockholders under the 2004 Plan. The awards under the 2004 Plan may include options, restricted stock units, stock appreciation rights and performance shares.

The Company terminated the 1995 Plan in fiscal 2007. The termination of the 1995 Plan did not affect options outstanding at the time of termination. At May 31, 2009, there were approximately 219,000 shares available for grant under the 2004 Plan. There were no shares 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 generally vest annually, in equal increments, over a five-year period beginning one year after the grant date. Options granted to non-employee directors generally vest annually, in equal installments, over a two-year period beginning one year after the grant date. Under all stock option plans, the option term cannot exceed 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.

Stock option activity and related information for the year ended May 31, 2009 is as follows:

	Number of Options	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Aggregate Intrinsic Value (In thousands)
Outstanding at May 31, 2008	457,830		$ 7.39	
Granted				
Exercised	(62,950)		$ 4.32	$ 538
Cancelled	(37,800)		$ 10.17	
Outstanding at May 31, 2009	357,080	5.0	$ 7.64	$ 1,314
Vested or expected to vest at May 31, 2009	347,535	5.0	$ 7.64	$ 1,278
Exercisable at May 31, 2009	276,680	4.7	$ 7.78	$ 979

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

There were no options granted in fiscal 2009, 2008 or 2007. For grants prior to fiscal 2007 the Company used the Black-Scholes option pricing model to estimate grant date fair value for each stock option granted. Expected volatility was based on the historic volatility of the Company s stock. The risk-free rate was based on the applicable United States Treasury Note rate. The expected life of the option was based on historical and expected future exercise behavior.

The total intrinsic value of stock options exercised during fiscal 2009, 2008, and 2007 was $0.5 million, $2.5 million and $6.2 million, respectively.

The following table summarizes information about stock options at May 31, 2009:

		Stock Options Outstanding			Stock Options Exercisable		
Range of Exercise Price		Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Options Exercisable	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)
$2.13	$ 2.41	25,000	$ 2.24	1.3	25,000	$ 2.24	1.3
3.03	3.70	34,400	3.41	3.0	34,400	3.41	3.0
4.60	5.49	106,700	4.85	5.6	65,300	4.79	5.6
8.93	12.20	190,980	10.67	5.5	151,980	10.96	5.2
$2.13	$12.20	357,080	$ 7.64	5.0	276,680	$ 7.78	4.7

Nonvested Deferred Shares

The Company issued nonvested deferred shares in fiscal 2009, 2008 and 2007. A portion of the shares awarded to employees vest after three years only if certain performance conditions are satisfied and the remaining shares generally vest in five equal annual installments beginning one year after the grant. All shares awarded to non-employee directors vest after three years only if certain performance conditions are satisfied. Based on the actual performance as measured against the performance criteria, the performance-based portion of the award can range from zero to one hundred percent of the original award grant for the fiscal 2009, 2008 and 2007 grants. The Company s policy is to issue shares upon vesting from its treasury shares, if available. The fiscal 2009 and 2008 grants also provide for an additional award of up to 50% of the original performance-based award in the form of phantom shares. The phantom share awards do not vest unless certain stretch financial targets are achieved and are settled in cash.

Deferred shares are valued at the market value of the Company s common stock at the grant date. Deferred share expense, net of estimated forfeitures, is generally recognized over the vesting period on a straight-line basis. The expense for the phantom and performance based shares is recognized over the service period based on management s assessment of the likelihood of achieving the stretch performance targets. Since the phantom share award is paid in cash, the estimated liability is marked to market based on changes in the value of Matrix Service Company Common Stock if a payout is considered probable.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

The following table reflects nonvested deferred share activity and related information for the year ended May 31, 2009:

Deferred Shares	Shares	Weighted Average Grant Date Fair Value	
Nonvested shares at May 31, 2008	502,830	$	21.41
Shares granted	374,015	$	11.97
Shares vested and released	(83,370)	$	20.80
Shares cancelled	(47,925)	$	18.15
Nonvested shares at May 31, 2009	745,550	$	16.98

In fiscal 2009, due to the current level of earnings and a reduced earnings forecast, the Company made the determination that the likelihood of achieving the minimum financial threshold required for the vesting of approximately 368,000 performance based shares issued in fiscal 2009 and 2008 was low. Therefore, pretax expense of $1.6 million previously recognized was reversed and the Company will not recognize future expense on these grants unless the financial outlook unexpectedly improves. Of the expense reversed, $0.7 million was originally recorded in fiscal 2008. Additionally, the Company does not expect to achieve threshold financial performance for the phantom stock awarded in fiscal 2009 and 2008; therefore, no expense has been recognized.

There were 319,370 and 263,130 deferred shares granted in fiscal 2008 and 2007 with average grant date fair values of $25.77 and $14.79, respectively. There were 83,370 and 59,590 deferred shares that vested and were released in fiscal 2009 and 2008 with weighted average fair values of $11.25 and $28.01, respectively. There were no deferred shares that vested and were released in fiscal 2007.

Note 11. 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, nonvested deferred shares, and convertible securities. Stock options are considered dilutive whenever the exercise price is less than the average market price of the stock during the period and antidilutive whenever the exercise price exceeds the average market price of the common stock during the period. Nonvested deferred shares are considered dilutive (antidilutive) whenever the average market value of the shares during the period exceeds (is less than) the sum or the related average unamortized compensation expense during the period plus the related hypothetical excess tax benefit estimated to result from the shares upon vesting. Convertible debt is considered dilutive when its interest (net of tax) per common share obtainable on conversion is less than basic earnings per share and antidilutive whenever its interest (net of tax) per common share obtainable on conversion exceeds basic earnings per share. Stock options, nonvested deferred shares, and convertible debt are considered antidilutive in the event of a net loss.

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.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

The computation of basic and diluted EPS is as follows:

	Fiscal Year Ended May 31,		
	2009	2008	2007
	(In thousands, except per share data)		
Basic EPS:			
Net income	$ 30,589	$ 21,414	$ 19,171
Weighted average shares outstanding	26,121	26,427	23,056
Basic EPS	$ 1.17	$ 0.81	$ 0.83
Diluted EPS:			
Net income	$ 30,589	$ 21,414	$ 19,171
Convertible notes interest expense (net of tax)			731
Adjusted net income	$ 30,589	$ 21,414	$ 19,902
Weighted average shares outstanding basic	26,121	26,427	23,056
Dilutive stock options	148	352	430
Dilutive nonvested deferred shares	121	96	24
Dilutive convertible note shares			3,242
Dilutive weighted average shares	26,390	26,875	26,752
Diluted EPS	$ 1.16	$ 0.80	$ 0.74

The following securities are considered antidilutive and have been excluded from the calculation of diluted earnings per share:

	Fiscal Year Ended May 31,		
	2009	2008	2007
	(In thousands)		
Stock options	21		
Nonvested deferred shares	132	133	
Total antidilutive securities	153	133	

Note 12. Employee Benefit Plans

The Company sponsors defined contribution savings plans for all eligible employees meeting length of service requirements. Under the primary plan, participants may contribute an amount up to 25% of pretax annual compensation subject to certain limitations. The Company matches 100% of the first 3% of employee contributions and 50% of the next 2% of employee contributions. The Company matching contributions vest immediately.

The Company recognized cost relating to the primary plan of $3.2 million, $2.8 million and $1.5 million for the fiscal years ended May 31, 2009, 2008 and 2007, respectively.

Effective October 1, 2008 the Company established a defined contribution savings plan for all eligible Canadian employees. Company contributions to the plan were less than $0.1 million in fiscal 2009.

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 primary services of our Construction Services segment are aboveground storage tanks for the bulk storage/terminal industry, capital construction for the downstream petroleum industry, specialty construction, and electrical/instrumentation services for various industries. These services, including civil/structural, mechanical, piping, electrical and instrumentation, millwrighting, and fabrication, are provided for projects of varying complexities, schedule durations, and budgets. Our project experience includes renovations, retrofits, modifications and expansions to existing facilities as well as construction of new facilities.

The primary services of our Repair and Maintenance Services segment are aboveground storage tank repair and maintenance services including tank inspection, cleaning and ASME code repairs, planned major and routine maintenance for the downstream petroleum industry, specialty repair and maintenance services and electrical and instrumentation repair and maintenance.

Other consists of operating activity related to previously disposed of businesses and certain 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. Intersegment sales and transfers are recorded at cost; therefore, no intercompany profit or loss recognized.

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

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Annual Results of Operations

(In thousands)

	Construction Services	Repair & Maintenance Services	Other	Total
Fiscal Year 2009				
Gross revenues	$ 422,223	$ 295,579	$	$ 717,802
Less: inter-segment revenues	26,983	1,099		28,082
Consolidated revenues	395,240	294,480		689,720
Gross profit	50,959	43,364		94,323
Operating income	22,111	25,206		47,317
Income before income tax expense	21,973	25,786		47,759
Net income	14,207	16,382		30,589
Segment assets	154,817	112,929	35,705	303,451
Capital expenditures	2,586	2,316	5,081	9,983
Depreciation and amortization expense	6,271	4,489		10,760
Fiscal Year 2008				
Gross revenues	$ 472,696	$ 278,818	$	$ 751,514
Less: inter-segment revenues	16,809	3,404		20,213
Consolidated revenues	455,887	275,414		731,301
Gross profit	33,081	42,036		75,117
Operating income (loss)	8,579	25,997	(25)	34,551
Income (loss) before income tax expense	7,950	25,791	(25)	33,716
Net income (loss)	5,483	15,946	(15)	21,414
Segment assets	150,174	93,052	31,367	274,593
Capital expenditures	9,272	4,363	4,667	18,302
Depreciation and amortization expense	4,966	3,407		8,373
Fiscal Year 2007				
Gross revenues	$ 376,849	$ 277,556	$	$ 654,405
Less: inter-segment revenues	10,689	3,870		14,559
Consolidated revenues	366,160	273,686		639,846
Gross profit	29,494	36,392		65,886
Operating income (loss)	11,567	21,556	(73)	33,050
Income (loss) before income tax expense	10,394	20,793	(73)	31,114
Net income (loss)	6,498	12,718	(45)	19,171
Segment assets	136,780	98,737	7,392	242,909
Capital expenditures	6,850	4,319	1,951	13,120
Depreciation and amortization expense	3,586	2,914		6,500

Matrix Service Company

Notes to Consolidated Financial Statements (continued)

Geographical information is as follows:

	Revenues Fiscal Year 2009	Fiscal Year 2008 (In thousands)	Fiscal Year 2007
Domestic	$ 668,620	$ 718,276	$ 624,002
International	21,100	13,025	15,844
	$ 689,720	$ 731,301	$ 639,846

	Long-Lived Assets May 31, 2009	May 31, 2008 (In thousands)	May 31, 2007
Domestic	$ 87,243	$ 77,897	$ 66,473
International	4,023	4,352	3,379
	$ 91,266	$ 82,249	$ 69,852

Segment revenue from external customers by market is as follows:

	Construction Services	Repair & Maintenance Services (In thousands)	Total
Fiscal Year 2009			
Aboveground Storage Tanks	$ 177,821	$ 166,348	$ 344,169
Downstream Petroleum	144,179	106,149	250,328
Electrical and Instrumentation	45,874	21,983	67,857
Specialty	27,366		27,366
Total	$ 395,240	$ 294,480	$ 689,720
Fiscal Year 2008			
Aboveground Storage Tanks	$ 201,446	$ 167,970	$ 369,416
Downstream Petroleum	156,371	89,001	245,372
Electrical and Instrumentation	19,975	18,443	38,418
Specialty	78,095		78,095
Total	$ 455,887	$ 275,414	$ 731,301
Fiscal Year 2007			
Aboveground Storage Tanks	$ 159,274	$ 125,236	$ 284,510

Downstream Petroleum	120,828	120,557	241,385
Electrical and Instrumentation	32,439	27,893	60,332
Specialty	53,619		53,619
Total	$ 366,160	$ 273,686	$ 639,846

Information about Significant Customers

In fiscal 2009, one customer accounted for 11% of our consolidated revenue and 14% of our Construction Services revenue. Another customer accounted for 10% of our consolidated revenue and 12% of our Repair and Maintenance Services revenue and an additional customer accounted for 20% of our Repair and Maintenance Services revenue.

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Matrix Service Company

Notes to Consolidated Financial Statements (continued)

In fiscal 2008, one customer accounted for 16% of our consolidated revenue and 21% of our Construction Services revenue. Another customer accounted for 13% of our Construction Services revenue. An additional customer accounted for 18% of our Repair and Maintenance Services revenue.

In fiscal 2007, one customer accounted for 14% of our consolidated revenue and 23% of our Construction Services revenue. Two additional customers accounted for 12% and 13% of our Construction Services revenue. Three other customers represented 20%, 13% and 11% of our Repair and Maintenance Services revenue, respectively.

Matrix Service Company

Quarterly Financial Data (Unaudited)

Fiscal Years Ended May 31, 2009 and 2008

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share amounts)			
Fiscal Year 2009				
Revenues	$ 186,650	$ 176,937	$ 146,262	$ 179,871
Gross profit	26,671	26,369	17,961	23,322
Net income	9,504	10,128	4,212	6,745
Earnings per common share:				
Basic	0.36	0.39	0.16	0.26
Diluted	0.36	0.38	0.16	0.26
Fiscal Year 2008				
Revenues	$ 161,327	$ 194,734	$ 181,120	$ 194,120
Gross profit	18,904	11,246	21,001	23,966
Net income	6,336	210	6,002	8,866
Earnings per common share:				
Basic	0.24	0.01	0.23	0.34
Diluted	0.23	0.01	0.22	0.34

The Company recorded pretax charges of $1.5 million, $16.0 million, $2.5 million and $0.8 million in the first through fourth quarters of fiscal 2008 related to a Gulf Coast LNG construction project. There were no losses recorded in fiscal 2009 relating to this project.

The sum of earnings per share for the four quarters may not equal the total earnings per share for the year due to changes in the average number of common shares outstanding and rounding.

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Matrix Service Company

Schedule II Valuation and Qualifying Accounts

May 31, 2009, 2008 and 2007

(In thousands)

COL. A	COL. B	COL. C ADDITIONS			COL. D		COL. E
	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Describe	Deductions	Describe	Balance at End of Period
Fiscal Year 2009							
Deducted from asset accounts:							
Allowance for doubtful accounts	$ 269	$ 441	$		$		$ 710
Valuation reserve for deferred tax assets	2,377				(1,603)(E)		774
Total	$ 2,646	$ 441	$		$ (1,603)		$ 1,484
Fiscal Year 2008							
Deducted from asset accounts:							
Allowance for doubtful accounts	$ 260	$ 1,161	$		$ (1,152)(A)		$ 269
Valuation reserve for deferred tax assets	2,149	467(B)			(239)(C)		2,377
Total	$ 2,409	$ 1,628	$		$ (1,391)		$ 2,646
Fiscal Year 2007							
Deducted from asset accounts:							
Allowance for doubtful accounts	$ 190	$ 189	$		$ (119)(A)		$ 260
Contract disputes reserve	5,390				(5,390)(A)		
Valuation reserve for deferred tax assets	3,431				(1,282)(D)		2,149
Total	$ 9,011	$ 189	$		$ (6,791)		$ 2,409

(A) Receivables written off against allowance for doubtful accounts and contract dispute reserve. The write off in fiscal 2008 relates to a receivable previously classified as a contract dispute receivable.

(B) An excess foreign tax credit was generated in fiscal 2008 for which the current and future utilization is doubtful. Therefore, a valuation allowance for the full amount of the credit was recorded.

(C) Operating loss carryforwards previously reserved were utilized resulting in an adjustment to goodwill and a reduction to the valuation reserve of $218. The remaining reduction was due to certain miscellaneous adjustments.

(D) Operating loss carryforwards previously reserved were utilized or deemed utilizable resulting in a reduction in the valuation reserve of $921. The recognition of the operating loss carryforward resulted in a $157 charge to goodwill and $764 reduction of the fiscal 2007 tax provision. The remaining reduction was due to miscellaneous adjustments.

(E) Operating loss carryforwards previously reserved were utilized or deemed utilizable resulting in a reduction in the valuation reserve of $1,603. The recognition of the operating loss carryforward resulted in a $646 charge to goodwill and a reduction of the fiscal 2009 tax provision of $957.

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

None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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 disclosure 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 disclosure controls and procedures. We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of May 31, 2009. 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 at May 31, 2009.

Management s Report on Internal Control over Financial Reporting

See Management s Report on Internal Control over Financial Reporting set forth in Item 8, Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There have been no changes during the fourth quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item with respect to the Company s directors and corporate governance is incorporated herein by reference to the sections entitled Proposal Number 1: Election of Directors and Corporate Governance and Board Matters in the Company s definitive Proxy Statement for the 2009 Annual Meeting of Stockholders (Proxy Statement). The information required by this item with respect to the Company s executive officers is incorporated herein by reference to the section entitled Executive Officer Information in the Proxy Statement. The information required by this item with respect to the Section 16 ownership reports is incorporated herein by reference to the section entitled Section 16(a) Beneficial Ownership Reporting Compliance in the Proxy Statement.

The Company has adopted a Code of Business Conduct and Ethics applicable to all directors, officers and employees, including the principal executive officer, principal financial officer and principal accounting officer of the Company. In addition, we have adopted Corporate Governance Guidelines for the Board of Directors and Charters for the Audit, Compensation and Nominating and Corporate Governance Committees of the Board of Directors. The current version of these corporate governance documents is publicly available in the Investors section of the Company s website at www.matrixservice.com under Corporate Governance. If we make any substantive amendments to the Code of Business Conduct and Ethics, or grant any waivers, including implicit waivers, from the Code of Business Conduct and Ethics applicable to the principal executive officer, principal financial officer or principal accounting officer, or any person performing similar functions, we will disclose such amendment or waiver on our website or in a report on Form 8-K.

Item 11. Executive Compensation

The information required by this item is incorporated herein by reference to the sections entitled Proposal Number 1: Election of Directors and Executive Officer Compensation in the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated herein by reference to the sections entitled Securities Authorized for Issuance Under Executive Compensation Plans and Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is incorporated herein by reference to the section entitled Proposal Number 1: Election of Directors and Certain Relationships and Related Transactions in the Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by this item is incorporated herein by reference to the sections entitled Fees of Independent Registered Public Accounting Firm and Audit Committee Pre-Approval Policy in the Proxy Statement.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Financial Statements of the Company

The following financial statements and supplementary data are filed as a part of this report under Item 8 Financial Statements and Supplementary Data in this Annual Report on Form 10-K:

Financial Statements of the Company

(2) Financial Statement Schedules

The financial statement schedule is filed as a part of this report under Schedule II Valuation and Qualifying Accounts for the three fiscal years ended May 31, 2009, 2008, and 2007 immediately following Quarterly Financial Data (Unaudited). All other schedules are omitted because they are not applicable or the required information is shown in the financial statements, or notes thereto, included herein.

(3) The following documents are included as exhibits to this Annual Report on Form 10-K:

3.1	Amended and Restated Certificate of Incorporation (Exhibit 4.1 to the Company s Registration Statement on Form S-3 (File No. 333-156814) filed January 21, 2009 is hereby incorporated by reference.
3.2	Certification of Designations, Preferences and Rights of Series B Junior Preferred Stock dated November 12, 1999 (Exhibit 3.2 to the Company s Registration Statement on Form S-3 (File No. 333-117077) filed July 1, 2004 is hereby incorporated by reference).
3.3	Certificate of Increase of Authorized Number of Shares of Series B Junior Participating Preferred Stock pursuant to Section 151 of the General Corporation Law of the State of Delaware dated May 1, 2005 (Exhibit 3.5 to the Company s Annual Report on Form 10-K (File No. 1-15461), filed August 17, 2005, is hereby incorporated by reference).
3.4	Certificate of Increase of Authorized Number of Shares of Series B Junior Participating Preferred Stock pursuant to Section 151 of the General Corporation Law of the State of Delaware dated October 23, 2006 (Exhibit 3.7 to the Company s Annual Report on Form 10-K (File No. 1-15461) filed August 14, 2007, is herby incorporated by reference).
3.5	Amended and Restated Bylaws (Exhibit 3 to the Company s Current Report on Form 8-K (File No. 1-15461) filed April 7, 2009, is hereby incorporated by reference).
4	Specimen Common Stock Certificate (Exhibit 4.1 to the Company s Registration Statement on Form S-1 (File No. 33-36081), filed July 26, 1990, is hereby incorporated by reference).
+10.1	Matrix Service 1990 Incentive Stock Option Plan (Exhibit 10.14 to the Company s Registration Statement on Form S-1 (File No. 333-56945), as amended, filed June 12, 1990, is hereby incorporated by reference).
+10.2	Matrix Service 1991 Incentive Stock Option Plan (Exhibit 10.1 to the Company s Registration Statement on Form S-8 (File No. 33-36081), filed July 26, 1990, is hereby incorporated by reference).
+10.3	Matrix Service 1995 Nonemployee Directors Stock Option Plan (Exhibit 4.3 to the Company s Registration Statement on Form S-8 (File No. 333-2771), filed April 24,1996, is hereby incorporated by reference).
+10.4	Matrix Service 2004 Stock Incentive Plan (Exhibit A to the Company s Proxy Statement filed on September 15, 2006 (File No. 1-15461), is hereby incorporated by reference).
+10.5	Amendment 1 to Matrix Service Company 2004 Stock Incentive Plan (Exhibit 10 to Amended Schedule 14A filed on October 4, 2006 (File No. 1-15461) is hereby incorporated by reference).
+10.6	Amendment 2 to Matrix Service Company 2004 Stock Incentive Plan (Exhibit 10.6 to the Company s Annual Report on Form 10-K (File No. 1-15461) filed August 5, 2008, (the Fiscal 2008 10-K) is hereby incorporated by reference).
+10.7	Form of Restricted Stock Unit Award Agreement for non-employee directors (2004 Stock Incentive Plan) (Exhibit 10.7 to the Fiscal 2008 10-K is hereby incorporated by reference).
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+10.10	Form of Amendment to Severance Agreement (Senior Executives), (Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q (File No. 1-15461), filed January 8, 2009 is hereby incorporated by reference).

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+10.11	Form of Management Retention Agreement (Exhibit 10.7 to the Company s current report on Form 8-K (File No. 1-15461), filed October 27, 2006 is hereby incorporated by reference).
+10.12	Form of Amendment to Severance Agreement (Key Employees), (Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q (File No. 1-15461), filed January 8, 2009 is hereby incorporated by reference).
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+10.15	Amendment No. 1 to the Matrix Service 1995 Nonemployee Directors Stock Option Plan (Exhibit B to the Company s 2005 Proxy Statement filed on September 16, 2005, is hereby incorporated by reference).
+10.16	Amended and Restated Deferred Compensation Plan for Members of the Board of Directors (Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q (File No. 1-15461), filed January 8, 2009 is hereby incorporated by reference).
10.17	Rights Agreement (including a form of Certificate of Designation of Series B Junior Participating Preferred Stock as Exhibit A thereto, a form of Rights Certificate as Exhibit B thereto and a summary of Rights to Purchase Preferred Stock as Exhibit C thereto) dated November 2, 1999, (Exhibit 1 to the Company s current report on Form 8-K (File No. 1-15461), filed November 9, 1999, is hereby incorporated by reference).
10.18	Amendment No. 1 to Rights Agreement effective April 21, 2005 (Exhibit 10.4 to the Company s Current Report on Form 8-K (File No. 1-15461), filed April 25, 2005, is hereby incorporated by reference).
10.19	Amendment No. 2 to Rights Agreement effective as of October 3, 2005 (Exhibit 10.3 to the Company s Current Report on Form 8-K (File No. 1-15461), filed on October 4, 2005, is hereby incorporated by reference).
10.20	Equity Interests Purchase Agreement dated as of March 7, 2003 by and among Hake Acquisition Corp., Matrix Service Company, and the Holders of the Equity Interests of The Hake Group of Companies (Exhibit 99.1 to the Company s current report on Form 8-K (File No. 1-15461), filed March 24, 2003, is hereby incorporated by reference).
10.21	Second Amended and Restated Credit Agreement dated as of November 30, 2006, among the Company, as Borrower, the Lenders party thereto, J.P. Morgan Chase Bank, N.A., as Administrative Agent and J.P. Morgan Securities Inc. as Sole Bookrunner and Sole Lead Arranger (filed as Exhibit 10 to the Company s Current Report on Form 8-K (File No. 1-15461), filed on December 6, 2006, is hereby incorporated by reference).
10.22	First Amendment to Second Amended and Restated Credit Agreement dated as of July 6, 2007 (Exhibit 10 to the Company s Current Report on Form 8-K (File No. 1-15461), filed July 11, 2007 is hereby incorporated by reference).
10.23	Second Amendment to Second Amended and Restated Credit Agreement (Exhibit 10 to the Company s Current Report on Form 8-K (File No. 1-15461), filed February 13, 2009, is hereby incorporated by reference).
10.24	Securities Purchase Agreement dated October 3, 2005 (Exhibit 10.1 to the Company s Current Report on Form 8-K (File No. 1-15461), filed October 4, 2005, is hereby incorporated by reference).

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10.25	Registration Rights Agreement dated October 3, 2005 (Exhibit 10.2 to the Company s Current Report on Form 8-K (File No. 1-15461), filed October 4, 2005, is hereby incorporated by reference).
10.26	Lump Sum Turnkey Agreement dated May 6, 2005 among the Company, Diamond LNG LLC and Bechtel Corporation (Exhibit 10.34 to the Company s Annual Report on Form 10-K (File No. 1-15461) filed August 17, 2005 is hereby incorporated by reference).
*21	Subsidiaries.
*23	Consent of Independent Registered Public Accounting Firm Deloitte & Touche LLP.
*31.1	Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 CEO.
*31.2	Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 CFO.
*32.1	Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) CEO.
*32.2	Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) CFO.

* Filed herewith.
\+ Management Contract or Compensatory Plan.

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SIGNATURES

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

Matrix Service Company

Date: August 4, 2009

By: /s/ Michael J. Bradley

Michael J. Bradley,

President and Chief Executive Officer

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

Signatures	Title	Date
/s/ Mike Bradley **Mike Bradley**	President, Chief Executive Officer and Director (Principal Executive Officer)	August 4, 2009
/s/ Thomas E. Long **Thomas E. Long**	Vice President and Chief Financial Officer (Principal Financial Officer)	August 4, 2009
/s/ Kevin S. Cavanah **Kevin S. Cavanah**	Vice President Accounting and Financial Reporting (Principal Accounting Officer)	August 4, 2009
/s/ Michael J. Hall **Michael J. Hall**	Chairman of the Board of Directors	August 4, 2009
/s/ I. Edgar Hendrix **I. Edgar Hendrix**	Director	August 4, 2009
/s/ Paul K. Lackey	Director	August 4, 2009

______________________________ **Paul K. Lackey**		
/s/ Tom E. Maxwell	Director	August 4, 2009
______________________________ **Tom E. Maxwell**		
/s/ David E. Tippeconnic	Director	August 4, 2009
______________________________ **David E. Tippeconnic**		

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Index to Exhibits

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*23	Consent of Independent Registered Public Accounting Firm Deloitte & Touche LLP.
*31.1	Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 CEO.
*31.2	Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 CFO.
*32.1	Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) CEO.
*32.2	Certification Pursuant to 18 U.S.C. 1350 (section 906 of Sarbanes-Oxley Act of 2002) CFO.

* Filed herewith.
\+ Management Contract or Compensatory Plan.