METALS USA HOLDINGS CORP.
Form 10-Q
November 08, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

Commission File Number 001-34685

METALS USA HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**20-3779274**
(State or other jurisdiction	**(I.R.S. Employer**

of incorporation or organization)	**Identification No.)**
2400 E. Commercial Blvd., Suite 905	
Fort Lauderdale, Florida	**33308**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (954) 202-4000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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

Number of shares of common stock outstanding at November 1, 2012 of Metals USA Holdings Corp.: 37,102,523

Table of Contents

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains statements reflecting assumptions, expectations, projections, intentions or beliefs about future events that are intended as forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements included in this report, other than statements of historical fact, that address activities, events or developments that we expect, believe or anticipate will or may occur in the future are forward-looking statements. These statements appear in a number of places, including Management s Discussion and Analysis of Financial Condition and Results of Operations. These statements represent our reasonable judgment on the future based on various factors and using numerous assumptions and are subject to known and unknown risks, uncertainties and other factors that could cause our actual results and financial position to differ materially from those contemplated by the statements. You can identify these statements by the fact that they do not relate strictly to historical or current facts. They use words such as anticipate, believe, estimate, expect, forecast, may, should, plan, project and other words of similar meaning. In particular, these include, but are not limited to, statements relating to the following:

- *projected operating or financial results, including anticipated cash flows from operations and asset sale proceeds;*
- *expectations regarding capital expenditures, interest expense and other payments;*
- *projected working capital needs;*
- *our beliefs and assumptions relating to our liquidity position, including our ability to adapt to changing market conditions; and*
- *our ability to compete effectively for market share with industry participants.*

Any or all of our forward-looking statements may turn out to be wrong. They can be affected by inaccurate assumptions or by known or unknown risks, uncertainties and other factors including, among others:

- *supply, demand, prices and other market conditions for steel and other commodities;*
- *the timing and extent of changes in commodity prices;*
- *the effects of competition on our business lines;*
- *the condition of the steel and metal markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions;*
- *the ability of our counterparties to satisfy their financial commitments;*
- *tariffs and other government regulations relating to our products and services;*

adverse developments in our relationship with both our key employees and unionized employees;

operational factors affecting the ongoing commercial operations of our facilities, including catastrophic weather-related damage, regulatory approvals, permit issues, unscheduled blackouts, outages or repairs, unanticipated changes in fuel costs or availability of fuel emission credits or workforce issues;

our ability to operate our businesses efficiently, manage capital expenditures and costs (including general and administrative expenses) and generate earnings and cash flow;

restrictive covenants in our indebtedness that may adversely affect our operational flexibility;

general political conditions and developments in the United States and in foreign countries whose affairs affect supply, demand and markets for steel, other metals and metal products;

our ability to retain key employees; and

our expectations with respect to our acquisition activity.

In addition, there may be other factors that could cause our actual results to be materially different from the results referenced in the forward-looking statements, some of which are included elsewhere in this report, including Management s Discussion and Analysis of Financial Condition and Results of Operations. Many of these factors will be important in determining our actual future results. Consequently, no forward-looking statement can be guaranteed. Our actual future results may vary materially from those expressed or implied in any forward-looking statements. All forward-looking statements contained in this report are qualified in their entirety by this cautionary statement. Forward-looking statements speak only as of the date they are made, and we disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report, except as otherwise required by applicable law.

Table of Contents

METALS USA HOLDINGS CORP. AND

SUBSIDIARIES

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. ***FINANCIAL STATEMENTS***

METALS USA HOLDINGS CORP. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except share amounts)

	September 30, 2012	December 31, 2011
Assets		
Current assets:		
Cash	$ 17.1	$ 12.1
Accounts receivable, net of allowance of $5.7 and $6.9, respectively	228.6	212.2
Inventories	426.4	402.5
Deferred income tax asset	5.4	7.9
Prepayments and other	4.8	9.4
Total current assets	682.3	644.1
Property and equipment, net	250.0	247.8
Intangible assets, net	31.2	26.6
Goodwill	54.8	52.8
Other assets	11.1	13.5
Total assets	$ 1,029.4	$ 984.8
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 113.2	$ 110.0
Accrued liabilities	38.1	29.7
Current portion of long-term debt	1.0	1.0
Total current liabilities	152.3	140.7
Long-term debt, less current portion	452.8	467.6
Deferred income tax liability	99.6	97.1
Other long-term liabilities	16.7	22.3
Total liabilities	721.4	727.7
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.01 par value, 10,000,000 shares authorized, none issued or outstanding at September 30, 2012 and December 31, 2011		
Common stock, $0.01 par value, 140,000,000 shares authorized, 37,109,727 issued and 37,102,523 outstanding at September 30, 2012, and 37,059,236 issued and 37,058,507 outstanding at December 31, 2011	0.4	0.4
Additional paid-in capital	233.2	231.3
Retained earnings	74.1	25.1
Accumulated other comprehensive income	0.4	0.3
Treasury stock, at cost - 7,204 shares at September 30, 2012 and 729 shares at December 31, 2011	(0.1)	

Total stockholders equity		308.0		257.1
Total liabilities and stockholders equity	$	1,029.4	$	984.8

See notes to unaudited condensed consolidated financial statements.

4

Table of Contents

METALS USA HOLDINGS CORP. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

(in millions, except per share amounts)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net sales	$ 483.7	$ 492.3	$ 1,546.1	$ 1,430.2
Operating costs and expenses:				
Cost of sales (exclusive of operating and delivery, and depreciation and amortization shown below)	372.8	379.8	1,194.3	1,092.4
Operating and delivery	49.4	44.0	151.4	131.0
Selling, general and administrative	28.4	28.3	84.0	83.0
Depreciation and amortization	5.8	5.0	16.7	15.4
Gain on sale of property and equipment	(0.1)	(0.1)	(0.2)	
Operating income	27.4	35.3	99.9	108.4
Other (income) expense:				
Interest expense	9.0	9.3	27.4	27.6
Other (income) expense, net	(0.2)	0.1	(0.2)	0.1
Income before income taxes	18.6	25.9	72.7	80.7
Provision for income taxes	4.9	9.2	23.7	30.1
Net income	$ 13.7	$ 16.7	$ 49.0	$ 50.6
Income per share:				
Income per share basic	$ 0.37	$ 0.45	$ 1.32	$ 1.37
Income per share diluted	$ 0.37	$ 0.45	$ 1.31	$ 1.36
Number of common shares used in the per share calculation:				
Basic	37.1	37.1	37.1	37.0
Diluted	37.4	37.3	37.4	37.3
Net income	$ 13.7	$ 16.7	$ 49.0	$ 50.6
Other comprehensive income (loss):				
Foreign currency translation adjustments	0.1	(0.3)	0.1	(0.3)
Deferred hedging gains				0.1
Total other comprehensive income (loss)	0.1	(0.3)	0.1	(0.2)
Total comprehensive income	$ 13.8	$ 16.4	$ 49.1	$ 50.4

See notes to unaudited condensed consolidated financial statements.

5

Table of Contents

METALS USA HOLDINGS CORP. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Cash flows from operating activities:		
Net income	$ 49.0	$ 50.6
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Gain on sale of property and equipment	(0.2)	
Provision for bad debts	1.7	2.2
Depreciation and amortization	18.2	16.9
Amortization of debt issuance costs	2.5	2.1
Deferred income taxes	0.1	11.9
Stock-based compensation	1.8	1.2
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(16.7)	(70.9)
Inventories	(22.3)	(74.8)
Prepayments and other	4.6	5.4
Accounts payable and accrued liabilities	11.3	14.6
Other operating	(0.2)	2.2
Net cash provided by (used in) operating activities	49.8	(38.6)
Cash flows from investing activities:		
Sales of assets	0.3	0.2
Purchases of assets	(13.3)	(10.1)
Acquisition costs, net of cash acquired	(17.0)	(88.1)
Net cash used in investing activities	(30.0)	(98.0)
Cash flows from financing activities:		
Borrowings on credit facility	207.5	180.1
Repayments on credit facility	(221.5)	(42.7)
Repayments of long-term debt	(0.8)	(1.1)
Deferred financing costs	(0.1)	(2.9)
Exercise of stock options	0.1	
Net cash (used in) provided by financing activities	(14.8)	133.4
Net increase (decrease) in cash	5.0	(3.2)
Cash, beginning of period	12.1	16.6
Cash, end of period	$ 17.1	$ 13.4
Supplemental Cash Flow Information:		
Cash paid for interest	$ 18.5	$ 21.4
Cash paid for income taxes	$ 25.3	$ 15.8

Cash received for income taxes	$ (0.8)	$ (0.4)
Investments in property and equipment not paid	$ 0.8	$ 0.1

See notes to unaudited condensed consolidated financial statements.

METALS USA HOLDINGS CORP. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in millions)

1. Basis of Presentation and Summary of Significant Accounting Policies

Metals USA Holdings Corp. (Metals USA Holdings) and its wholly-owned subsidiaries, Flag Intermediate Holdings Corporation (Flag Intermediate) and Metals USA, Inc. (Metals USA) are referred to collectively herein as the Company, we or our. Metals USA s November 30 2005 acquisition by Apollo Management V L.P. (Apollo Management and together with its affiliated investment entities Apollo or Apollo V) is referred to herein as the Merger. The condensed consolidated financial statements include the accounts of Metals USA Holdings, Flag Intermediate, and Metals USA and its subsidiaries. Intercompany accounts and transactions have been eliminated in the condensed consolidated financial statements.

The interim condensed consolidated financial statements included herein are unaudited; however, they include adjustments of a normal recurring nature which, in our opinion, are necessary to present fairly the interim condensed consolidated financial information as of and for the periods indicated. Accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the entire year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and (iii) the reported amount of net sales and expenses recognized during the periods presented. Adjustments made with respect to the use of estimates often relate to improved information not previously available. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of financial statements; accordingly, actual results could differ from these estimates.

New Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05 Comprehensive Income (Topic 220): Presentation of Comprehensive Income (ASU 2011-05), which amends some of the guidance in ASC Topic 220 Comprehensive Income regarding how companies must present comprehensive income. The main provisions of ASU 2011-05 provide that an entity that reports items of other comprehensive income has the option to present comprehensive income in either a single statement or two separate statements. A single statement would contain the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for all comprehensive income. In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for all comprehensive income. The ASU is intended to increase the prominence of other comprehensive income in financial statements and to facilitate convergence of U.S. GAAP and International Financial Reporting Standards. The amendments in ASU 2011-05 are to be applied retrospectively. For public entities, the ASU is effective for fiscal years and interim periods within those years beginning after December 15, 2011. The Company adopted ASU 2011-05 within its condensed consolidated financial statements in the first quarter of 2012. ASU 2011-05 impacts presentation only and has no effect on the Company s financial condition, results of operations, or cash flows.

Table of Contents

2. Acquisitions

Gregor Technologies

On March 12, 2012, we acquired all of the issued and outstanding membership interests of Gregor Technologies, LLC and an affiliated company (Gregor) for $17.0. The purchase was funded with borrowings under our $500.0 amended and restated senior secured asset-based credit facility due 2015 (the ABL facility) and $3.0 of the purchase price was placed in escrow to secure seller s indemnity obligations with respect to certain representations and warranties.

Established in 1989, Gregor provides custom-crafted parts and assemblies to original equipment manufacturers in several end markets, including industrial equipment, manufacturing, scientific instruments, electronics, aerospace, homeland security and defense. Gregor operates a 70,000 square foot metal processing facility in Torrington, Connecticut. We believe the acquisition will broaden our participation in both new and existing end markets with Gregor s value-added processing and service offerings.

The excess of the aggregate purchase price over the estimated fair value of the net assets acquired was $3.3, which was allocated to goodwill. Goodwill arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of Metals USA and Gregor. The Gregor acquisition was a taxable business combination and as such, the entire amount of goodwill recognized is expected to be deductible for income tax purposes. All of the goodwill was assigned to the Company s Flat Rolled and Non-Ferrous Segment (see Note 4).

The estimated amount of goodwill and related allocations of the fair values assigned to assets acquired and liabilities assumed are based on preliminary data and are subject to change based on the final valuation of tangible and intangible assets. In connection with management s preliminary valuation, $0.6 was reclassified from intangible assets to goodwill during the second quarter of 2012 (see Note 4 for further discussion of Gregor s intangible assets), and $0.9 was reclassified from goodwill to inventory during the third quarter of 2012. The following table presents the preliminary allocation of the acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values:

Accounts receivable, trade	$ 1.4
Inventories	1.6
Property and equipment	3.6
Customer list intangible assets	6.1
Trade name intangible assets	0.5
Technology intangible assets	1.3
Goodwill	3.3
Total assets acquired	17.8
Accounts payable and accrued liabilities	0.8
Total liabilities assumed	0.8
Net assets acquired	$ 17.0

Results for the nine months ended September 30, 2012 include operating results from the Gregor acquisition from the date of the acquisition closing. Gregor contributed $6.1 of incremental sales and $0.8 of incremental operating income for the nine months ended September 30, 2012. Acquisition-related costs for the nine months ended September 30, 2012 amounted to approximately $0.6 and are included in selling, general and administrative expenses in the Company s condensed consolidated statement of operations and comprehensive income.

The pro forma effects of the Gregor acquisition would not have been material to our results of operations for the three months ended September 30, 2011 and the nine months ended September 30, 2011 and 2012, and therefore are not presented.

Table of Contents

The Richardson Trident Company

On March 11, 2011, we acquired all of the issued and outstanding stock of The Richardson Trident Company (Trident). Trident s results of operations have been included in the condensed consolidated statement of operations and comprehensive income since the date of acquisition. Trident is a general line metal service center with fabricating capabilities designed to service the oil and gas industry, and is also a wholesale distributor of metals, plastics and electronic parts. Trident operates under The Richardson Trident Company and The Altair Company trade names. Trident s principal facility is in Richardson, Texas with branch locations in Houston, and Odessa, Texas; Tulsa, Oklahoma; Los Angeles, California; Boston, Massachusetts and Thomasville, Georgia. The Company paid $90.4 in cash for the stock of Trident, which included $54.2 for the repayment of Trident debt, and $1.8 in the form of a note payable, for a total purchase price of $92.2. The purchase was funded with borrowings under the ABL facility.

The excess of the aggregate purchase price over the estimated fair value of the net assets acquired was $8.3, which was allocated to goodwill. Goodwill arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of Metals USA and Trident. All of the goodwill was assigned to the Company s Flat Rolled and Non-Ferrous Segment. The Trident acquisition was a taxable business combination and as such, the entire amount of the goodwill recognized is expected to be deductible for income tax purposes. The customer list intangible asset will be amortized on an accelerated basis over twelve years based on its estimated useful life.

The following table presents the allocation of the acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values:

Cash	$ 2.2
Accounts receivable, trade	17.2
Inventories	18.1
Other current assets	0.1
Property and equipment	47.8
Customer list intangible asset	19.0
Trade name intangible asset	3.3
Goodwill	8.3
Total assets acquired	116.0
Accounts payable and accrued liabilities	23.8
Note payable	1.8
Total liabilities assumed	25.6
Net assets acquired	$ 90.4

Results for the nine months ended September 30, 2011 include operating results from the Trident acquisition from the date of the acquisition closing, which occurred on March 11, 2011. Trident contributed $42.6 and $90.9 of incremental sales and $3.1 and $6.1 of incremental operating income for the three and nine months ended September 30, 2011, respectively. Acquisition-related costs for the nine months ended September 30, 2011 amounted to approximately $1.5 million, which are included in selling, general and administrative expenses in the Company s condensed consolidated statement of operations and comprehensive income.

Trident provides a broad range of metals and processing services with a product mix that emphasizes aluminum, stainless steel and nickel. The majority of Trident s customer base operates in the oil and gas services sector. Trident also serves customers in the aerospace, defense and transportation industries. Processing services include precision sawing, boring, honing, slitting, sheeting, shearing and turning. Trident also offers supply chain solutions such as just-in-time delivery and value-added components required by original equipment manufacturers. As a result of the acquisition, we have increased our non-ferrous and value-added processing product and service offerings in the geographic areas and end markets that Trident currently serves.

9

Table of Contents

The following unaudited pro forma information presents our consolidated results of operations as if the Trident acquisition had occurred on January 1, 2011, after the effect of certain adjustments, including increased depreciation expense resulting from recording fixed assets at fair value, interest expense on the acquisition debt, amortization of certain identifiable intangible assets, severance costs for certain Trident employees that were terminated as of the acquisition date, certain other non-recurring costs, and a provision for income taxes for Trident, which was previously treated as an S corporation.

	Nine Months Ended September 30, 2011
Net sales	$ 1,456.0
Net income	$ 50.9
Earnings per share basic	$ 1.37
Earnings per share diluted	$ 1.36

3. Inventories

Inventories consist of the following:

	September 30, 2012	December 31, 2011
Raw materials		
Plates and Shapes	$ 166.2	$ 151.4
Flat Rolled and Non-Ferrous	206.9	198.5
Building Products	5.9	4.7
Total raw materials	379.0	354.6
Work-in-process and finished goods		
Flat Rolled and Non-Ferrous	37.2	38.8
Building Products	10.2	9.1
Total work-in-process and finished goods	47.4	47.9
Total inventories	$ 426.4	$ 402.5

Table of Contents

4. Goodwill and Intangible Assets

Changes in the carrying amounts of goodwill by segment for the nine months ended September 30, 2012 are as follows:

	As of December 31, 2011	Acquisitions/ Purchase Accounting Adjustments	Realization of Tax Benefits/Other	As of September 30, 2012
Plates and Shapes				
Gross Goodwill and Carrying Amount of Goodwill	$ 14.5	$	$ (0.2)	$ 14.3
Flat Rolled and Non-Ferrous				
Gross Goodwill and Carrying Amount of Goodwill	32.7	3.3		36.0
Building Products				
Gross Goodwill and Carrying Amount of Goodwill	2.2			2.2
Corporate				
Gross Goodwill	7.6		(1.1)	6.5
Impairments	(4.2)			(4.2)
Carrying Amount of Goodwill	3.4		(1.1)	2.3
Consolidated Total				
Gross Goodwill	57.0	3.3	(1.3)	59.0
Impairments	(4.2)			(4.2)
Carrying Amount of Goodwill	$ 52.8	$ 3.3	$ (1.3)	$ 54.8

Additions to goodwill recorded for the Flat Rolled and Non-Ferrous segment for the nine months ended September 30, 2012 are attributable to the Gregor acquisition, which closed on March 12, 2012, discussed in Note 2. Reductions to goodwill for the Corporate and Plates and Shapes segments for the nine months ended September 30, 2012 are primarily attributable to accounting for tax benefits associated with tax-deductible goodwill recognized in connection with the Merger and the acquisition of Port City Metal Services, which were taxable business combinations.

The carrying amounts of the Company s intangible assets are as follows:

	September 30, 2012	December 31, 2011
Customer lists	$ 67.8	$ 61.7
Less: Accumulated amortization	(44.2)	(41.4)
	$ 23.6	$ 20.3
Trade names	$ 7.1	$ 6.6
Less: Accumulated amortization	(1.5)	(1.1)
	$ 5.6	$ 5.5
Technology	$ 1.3	$
Less: Accumulated amortization		
	$ 1.3	$

Other intangible assets	$ 0.8	$ 0.8
Less: Accumulated amortization	(0.1)	
	$ 0.7	$ 0.8

Table of Contents

During the nine months ended September 30, 2012, we acquired an estimated $6.1 of customer list intangible assets, $0.5 of trade name intangible assets, and $1.3 of technology intangible assets as a result of the Gregor acquisition discussed in Note 2.

Aggregate amortization expense for the three months ended September 30, 2012 and 2011 was $1.1 and $0.6, respectively. Aggregate amortization expense for the nine months ended September 30, 2012 and 2011 was $3.3 and $2.4, respectively. Aggregate remaining amortization of our intangible assets is as follows:

For the Year Ending December 31,	**Estimated Amortization Expense**
2012 (remaining 3 months)	$ 1.1
2013	$ 4.5
2014	$ 4.2
2015	$ 3.8
2016	$ 3.3
Thereafter	$ 14.3

5. Fair Value Measurements

ASC Topic 820 Fair Value Measurements and Disclosures (ASC 820) defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 classifies the inputs used to measure fair value into the following hierarchy:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity, but which are significant to the fair value of the assets or liabilities as determined by market participants.

As of September 30, 2012, the Company held certain items that are required to be measured at fair value on a recurring basis. Our receivables, payables, prepayments and accrued liabilities are current assets and obligations and, accordingly, the recorded values are believed by management to approximate fair value. Our 11 $^{1}/_{8}$% Senior Secured Notes due 2015 (the Metals USA Notes) are thinly traded public debt instruments; accordingly, their market prices at any balance sheet date may not be representative of the prices which would be derived from a more active market. The fair value of the Company s debt that is not traded and is fixed-rate is estimated by discounting the interest payments and principal amount at the Company s current borrowing rate (yield to maturity). For floating rate debt that is not traded, fair value is not sensitive to interest rates since coupons float with Treasury or London Interbank Offered Rate (LIBOR) yields, and book value is a reasonable approximation of fair value after considering the stability of the Company s default risk. The fair value of the Company s debt is considered Level 2 in the ASC 820 fair value hierarchy. The estimated fair value of current and long-term debt at September 30, 2012 and December 31, 2011 was $460.8 and $476.4, respectively.

In December 2007, Ohio River Metal Services, which we acquired in December 2010, entered into an interest rate swap agreement in connection with the Jeffersonville, Indiana Industrial Revenue Bonds (IRBs) discussed in Note 8. The interest rate swap derivative is valued using market data which is derived by combining certain inputs with quantitative models and processes to generate interest rate forward curves and discount factors. The notional amount under the swap corresponds to the principal amount of one of the Jeffersonville IRBs, which was $4.0 as of September 30, 2012. The Company has categorized the swap contract as Level 2. The fair value of the interest rate swap liability was $0.6 as of September 30, 2012 and December 31, 2011. Pretax realized losses from the interest rate swap recognized as interest expense during the nine months ended September 30, 2012 and 2011 were not material.

Table of Contents

6. Other Assets

Other assets consist of the following:

	September 30, 2012	December 31, 2011
Deferred financing costs	$ 7.8	$ 9.7
Deferred debt offering costs	2.3	2.8
Other	1.0	1.0
Total other assets	$ 11.1	$ 13.5

Aggregate amortization of debt issuance costs for the three months ended September 30, 2012 and 2011 was $0.9 and $0.7, respectively. Aggregate amortization of debt issuance costs for the nine months ended September 30, 2012 and 2011 was $2.5 and $2.1, respectively.

7. Accrued Liabilities

Accrued liabilities consist of the following:

	September 30, 2012	December 31, 2011
Salaries and employee benefits	$ 13.8	$ 15.1
Income taxes		1.0
Taxes, other than income	4.8	3.4
Interest	8.9	2.6
Insurance	4.2	4.2
Audit and tax fees	1.3	0.7
Warranty liability	0.6	0.6
Lease terminations	0.7	0.2
Other	3.8	1.9
Total accrued liabilities	$ 38.1	$ 29.7

8. Debt

Debt consists of the following:

	September 30, 2012	December 31, 2011
ABL facility	$ 213.7	$ 227.7
Metals USA Notes	226.3	226.3
IRBs	12.4	12.6
Capital lease and other obligations	1.4	2.0
Total debt	453.8	468.6
Less current portion of debt	1.0	1.0
Total long-term portion of debt	$ 452.8	$ 467.6

The weighted average interest rates under the ABL facility for the three months ended September 30, 2012 and 2011 were 2.41% and 2.62%, respectively. The weighted average interest rates under the ABL facility for the nine months ended September 30, 2012 and 2011 were 2.48% and 2.93%, respectively.

Table of Contents

Senior Secured Asset-Based Revolving Credit Facility

On December 17, 2010, Flag Intermediate, Metals USA, and certain subsidiaries of Metals USA entered into an amended and restated loan and security agreement (the ABL Credit Agreement) with the lenders party thereto and Bank of America, N.A., as administrative agent and collateral agent. The ABL Credit Agreement provides for borrowings of up to $500.0 of Tranche A commitments and $35.0 of first-in last-out (FILO) Tranche A-1 commitments (which may be increased up to $750.0 at the option of Metals USA, including $35.0 under the FILO tranche)), under the 5-year, senior secured ABL facility that amended and restated Metals USA s then-existing $625.0 senior secured asset-based credit facility that was scheduled to mature on November 30, 2011.

On March 9, 2011, we activated $25.0 of the FILO tranche under the ABL facility. The ABL facility initially permitted us to borrow on a revolving basis through the earlier of November 30, 2015 and 60 days prior to the scheduled maturity of the Metals USA Notes, unless the Metals USA Notes are refinanced to a date more than 5 years and 60 days after the closing date of the ABL facility and/or repaid prior to such date. Substantially all of our subsidiaries are borrowers under the ABL facility.

On August 10, 2011, we amended the ABL facility by reducing the borrowing costs on the Tranche A commitments by 75 basis points and reducing the borrowing costs on the FILO tranche by 62.5 basis points. Under the amendment, the maturity date of the ABL facility was extended to the earlier of August 10, 2016 and 60 days prior to the scheduled maturity of the Metals USA Notes, unless the Metals USA Notes are refinanced to a date more than 5 years and 60 days after the closing date of the ABL facility and/or repaid prior to such date.

Borrowing Base. The maximum availability under the ABL facility is based on eligible receivables and eligible inventory, subject to certain reserves. Our borrowing availability fluctuates daily with changes in eligible receivables and inventory, less outstanding borrowings and letters of credit. The borrowing base is equal to:

- 85% of the net amount of eligible accounts receivable, plus

- the lesser of (x) 80% of the lesser of the original cost or market value of eligible inventory and (y) 90% of the net orderly liquidation value of eligible inventory, plus

- an incremental amount of the lesser of (x) the maximum commitments under the FILO tranche and (y) the sum of (i) 5% of the net amount of eligible accounts receivable and (ii) 5% of the net orderly liquidation value of eligible inventory during the effectiveness of any FILO tranche, less reserves.

The ABL facility provides sub-limits for up to $25.0 of swingline loans and up to $100.0 for the issuance of letters of credit. Both the face amount of any outstanding letters of credit and any swingline loans will reduce borrowing availability under the ABL facility on a dollar-for-dollar basis.

As of September 30, 2012, we had $447.1 of eligible collateral, $213.7 in outstanding advances, $20.2 in open letters of credit and $213.2 of additional borrowing capacity.

Guarantees and Security. Substantially all of our subsidiaries are defined as borrowers under the ABL Credit Agreement. The obligations under the ABL facility are guaranteed by Flag Intermediate and certain of our domestic subsidiaries and are secured by a first-priority lien and security interest in, among other things, accounts receivable, inventory and deposit accounts of Flag Intermediate, Metals USA and the subsidiaries of Metals USA party to the ABL Credit Agreement and a second-priority lien and security interest in, among other things, substantially all other tangible and intangible personal and real property owned by such companies, subject to certain exceptions.

Interest Rate and Fees. At Metals USA s option, interest accrues on the loans made under the ABL facility at either LIBOR plus a specified margin (set at 1.75% (3.25% for the FILO tranche) as of September 30, 2012), or the base rate (which is based off of the federal funds rate plus 0.50%, Bank of America s prime rate or LIBOR plus 1.00%), plus a specified margin (set at 0.75% (2.25% for the FILO tranche) as of September 30, 2012).

14

Under the ABL facility amendment that was executed on August 10, 2011, the specified margins over LIBOR were reduced by 75 basis points for the Tranche A commitments and 62.5 basis points for the FILO tranche. The marginal rates vary based on our average monthly excess availability (as defined in the ABL Credit Agreement). The applicable base rate and the effective LIBOR rate for the loans made under the ABL facility were 3.25% and 0.36%, respectively, as of September 30, 2012.

A commitment fee is payable on any unused commitment equal to 0.25% per annum to the lenders under the ABL facility if utilization under the facility exceeds 40.0% of the total commitments under the facility and a commitment fee equal to 0.375% per annum if utilization under the facility is less than or equal to 40.0% of the total commitments under the facility. Customary letter of credit fees are also payable, as necessary.

Certain Conditions Precedent and Covenants. As a condition precedent to any borrowing or issuance of a letter of credit, a material adverse effect shall not have occurred or exist. The ABL facility contains customary representations, warranties and covenants, including limitations on our ability to incur or guarantee additional debt, subject to certain exceptions, pay dividends, or make redemptions and repurchases, with respect to capital stock, repay debt, create or incur certain liens, make certain loans or investments, make acquisitions or investments, engage in mergers, acquisitions, asset sales, and engage in certain transactions with affiliates. The ABL facility requires a lock-box arrangement for collection of accounts receivable and proceeds from sales of inventory. Metals USA may make withdrawals from the lock-box unless an event of default exists or borrowing availability is less than the greater of (i) $50.0 and (ii) 12.5% of the lesser of (A) the borrowing base (not to exceed $62.5) and (B) the aggregate commitment. We do not have to maintain a minimum fixed charge coverage ratio (FCCR) as long as our borrowing availability is greater than or equal to the greater of (i) $45.0 and (ii) 10% of the lesser of the borrowing base and the aggregate commitment (the Minimum Availability). We must maintain an FCCR of at least 1.0 to 1.0 if borrowing availability falls below the Minimum Availability. For purposes of determining covenant compliance, the FCCR is determined by dividing (i) the sum of Adjusted EBITDA (as defined in the ABL Credit Agreement) minus income taxes paid in cash (excluding certain specified deferred taxes) minus non-financed capital expenditures by (ii) the sum of certain distributions paid in cash, cash interest expense and scheduled principal reductions on debt, and is calculated based on such amounts for the most recent period of four consecutive fiscal quarters for which financial statements are available. FCCR and Adjusted EBITDA are each calculated on a pro forma basis. As of September 30, 2012, our FCCR was 2.57. We were in compliance with all financial covenants as of September 30, 2012.

Certain Events of Default and Remedies. The ABL facility contains events of default with respect to: default in payment of principal when due, default in the payment of interest, fees or other amounts after a specified grace period, material breach of the representations or warranties, default in the performance of covenants, a default that causes or permits acceleration under any indebtedness with a principal amount in excess of a specified amount, certain bankruptcy events, certain ERISA violations, invalidity of certain security agreements or guarantees, material judgments, or a change of control. In the event of default, the ABL Credit Agreement may permit a majority of the lenders to: (i) restrict the amount of or refuse to make revolving loans; (ii) cause customer receipts to be applied against borrowings under the ABL facility which would cause Metals USA to suffer a rapid loss of liquidity and restrict the ability to operate on a day-to-day basis; (iii) restrict or refuse to provide letters of credit; or ultimately: (iv) terminate the commitments and the agreement; or (v) declare any or all obligations to be immediately due and payable if such default is not cured in the specified period required. Any payment default or acceleration under the ABL facility would also result in a default under the Metals USA Notes that would provide the holders of the Metals USA Notes with the right to demand immediate repayment.

Costs related to the establishment of the ABL facility, in addition to subsequent amendments to the ABL facility, were capitalized and are being charged to interest expense over the life of the ABL facility. Unamortized financing costs of $7.8 and $9.7 were included in other non-current assets as of September 30, 2012 and December 31, 2011, respectively.

Table of Contents

11 $^{1}/_{8}$% Senior Secured Notes Due 2015

On November 30, 2005, Flag Acquisition Corporation (Flag Acquisition) sold $275.0 aggregate principal amount of the Metals USA Notes. The Metals USA Notes bear interest at a rate per annum equal to 11 $^{1}/_{8}$%, payable semi-annually in arrears, on June 1 and December 1 of each year, commencing on June 1, 2006. The Metals USA Notes will mature on December 1, 2015. We may redeem some or all of the Metals USA Notes at a predetermined redemption price plus accrued and unpaid interest and additional interest, if any, to the applicable redemption date. If we experience a change of control and we do not redeem the Metals USA Notes, we will be required to make an offer to repurchase the Metals USA Notes at a price equal to 101% of the principal amount, plus accrued and unpaid interest and additional interest, if any, to the date of repurchase.

As a result of the Merger, Metals USA assumed the obligations of Flag Acquisition including the Metals USA Notes. All domestic operating subsidiaries of Metals USA have agreed, jointly and severally with Flag Intermediate (the Guarantors), to unconditionally and irrevocably guarantee Metals USA s obligations under the Metals USA Notes and the Indenture dated as of November 30, 2005 (the Metals USA Notes Indenture or the Indenture). Additionally, Flag Intermediate has unconditionally agreed to be a primary obligor of the due and punctual payment and performance of the obligations under the Indenture.

Metals USA Holdings is not a guarantor of the Metals USA Notes. There is a limitation on the amount of funds which can be transferred by the Guarantors to Metals USA Holdings in the form of dividends. Such amount available for distribution shall be increased by an amount equal to 50% of Consolidated Net Income, or reduced by an amount equal to 100% of Consolidated Net Loss, each as defined in the Indenture. As of September 30, 2012, $53.3 was available for general distribution under the restricted payment covenant contained in the Metals USA Notes Indenture.

The indebtedness evidenced by the Metals USA Notes and the guarantees rank: equally with all of our and the Guarantors existing and future senior indebtedness; junior in priority as to collateral that secures the ABL facility on a first-priority lien basis with respect to our and the Guarantors obligations under the ABL facility, any other debt incurred after December 1, 2005 that has a priority security interest relative to the Metals USA Notes in the collateral that secures the ABL facility, any hedging obligations related to the foregoing debt and all cash management obligations incurred with any lender under the ABL facility; equal in priority as to collateral that secures the Metals USA Notes and the guarantees on a first-priority lien basis with respect to our and the Guarantors obligations under any other equivalent priority lien obligations incurred after December 1, 2005; and senior to all of our and the Guarantors existing and future subordinated indebtedness. The Metals USA Notes will also be effectively junior to the liabilities of any non-guarantor subsidiaries.

The Metals USA Notes contain covenants that are customary for similar debt instruments, including limitations on our or the Guarantors ability to incur or guarantee additional debt, subject to certain exceptions, pay dividends, or make redemptions and repurchases with respect to capital stock, create or incur certain liens, make certain loans or investments, make acquisitions or investments, engage in mergers, acquisitions, asset sales and sale lease-back transactions, and engage in certain transactions with affiliates.

The Metals USA Notes Indenture contains certain customary events of default, including (subject, in some cases, to customary cure periods) defaults based on (i) the failure to make payments under the Metals USA Notes Indenture when due, (ii) breach of covenants, (iii) cross-defaults to other material indebtedness, (iv) bankruptcy events and (v) material judgments. We were in compliance with all financial covenants as of September 30, 2012.

Costs related to the establishment of the Metals USA Notes were capitalized and are being charged to interest expense over the life of the Metals USA Notes. Unamortized issuance costs of $2.3 and $2.8 were included in other non-current assets as of September 30, 2012 and December 31, 2011, respectively.

On October 24, 2012, Metals USA announced that it will seek to enter into a new term loan in an amount of approximately $275.0. The proceeds of the term loan would be used to refinance the Metal USA Notes; to reduce borrowings under the ABL facility; to pay costs, expenses and fees associated with the new term loan and the

Metals USA Notes refinancing; and for general corporate purposes, including working capital. The timing and size of the potential new term loan and the use of proceeds thereof are subject to market and other conditions, and we can make no assurances that such actions will take place at any specific time or at all.

Industrial Revenue Bonds

Metals USA is a conduit bond obligor on IRBs issued by the municipalities of Muskogee, Oklahoma and Jeffersonville, Indiana. The IRBs are secured by certain real estate, leasehold improvements and equipment acquired with proceeds from the IRBs. The Muskogee IRB is due in one lump sum of $5.7 on May 1, 2023. The Jeffersonville IRBs had principal amounts outstanding of $4.0 and $2.7 as of September 30, 2012, and are being redeemed in varying amounts annually through August 2021 and December 2027, respectively. The interest rates assessed on the IRBs vary from month to month. As of September 30, 2012, the weighted average variable interest rate on the IRBs was 0.45%. The IRBs place various restrictions on certain of our subsidiaries, including but not limited to maintenance of required insurance coverage, maintenance of certain financial ratios, limits on capital expenditures and maintenance of tangible net worth and are supported by letters of credit. We were in compliance with all financial covenants as of September 30, 2012.

9. Stockholders Equity

Common Stock

In accordance with our amended and restated certificate of incorporation, we are authorized to issue 140,000,000 shares of common stock, $0.01 par value. At September 30, 2012, 37,109,727 shares were issued and 37,102,523 shares were outstanding. At December 31, 2011, 37,059,236 shares were issued and 37,058,507 shares were outstanding.

Preferred Stock

Also in accordance with our amended and restated certificate of incorporation, Metals USA Holdings is authorized to issue 10,000,000 shares of preferred stock, $0.01 par value. At September 30, 2012 and December 31, 2011, no shares of preferred stock were issued and outstanding.

Additional Paid-In Capital

Changes in additional paid-in capital for the nine months ended September 30, 2012 consist of $1.8 of stock-based compensation expense (see Note 10) and $0.1 for amounts recognized attributable to the exercise of stock options.

Retained Earnings

The change in retained earnings for the nine months ended September 30, 2012 consists of $49.0 of net income.

Accumulated Other Comprehensive Income

The change in accumulated other comprehensive income for the nine months ended September 30, 2012 consists of $0.1 of foreign currency translation adjustments.

Treasury Stock

At September 30, 2012, 7,204 shares of the Company s common stock were held as treasury stock at a weighted average cost of $15.82 per share. At December 31, 2011, 729 shares of the Company s common stock were held as treasury stock at a cost of $15.01 per share. All such shares were used to satisfy applicable tax withholding obligations for certain participants upon vesting of restricted stock awards as described under *Restricted Stock* in Note 10 below.

Table of Contents

10. Stock-Based Compensation

Total stock-based compensation expense recognized for the three months ended September 30, 2012 and 2011 was $0.6 and $0.4, respectively. Total stock-based compensation expense recognized for the nine months ended September 30, 2012 and 2011 was $1.8 and $1.2, respectively. Stock-based compensation expense is included in our condensed consolidated statements of operations and comprehensive income in selling, general and administrative expense.

2005 Stock and Incentive Plan

Metals USA Holdings Amended and Restated 2005 Stock and Incentive Plan (the 2005 Plan) permits the issuance of options and restricted stock awards to employees and directors of the Company. The 2005 Plan has reserved for issuance up to 2.4 million shares of common stock. The 2005 Plan has two tranches of options, Tranche A and Tranche B. Tranche A options vest on a pro-rata basis over five years, have a term of ten years, and expire if not exercised. Tranche B options, which include both a service and a performance condition, vest on the eighth anniversary of the date of grant or earlier dependent on the satisfaction of an internal rate of return on capital invested, have a term of ten years from date of grant, and expire if not exercised.

Tranche A Options

As of September 30, 2012, Tranche A options for 393,824 shares were outstanding, 388,014 of which were exercisable. The weighted average exercise price of these options is $3.22 per share, with an aggregate intrinsic value of $4.0. The Tranche A options have a weighted average remaining contractual life of approximately 3.3 years. Compensation expense associated with the Tranche A options has been fully recognized as of September 30, 2012.

Tranche B Options

As of September 30, 2012, Tranche B options for 39,704 shares were outstanding, all of which were exercisable. The exercise price of these options is $2.30 per share, with an aggregate intrinsic value of $0.4. The Tranche B options have a weighted average remaining contractual life of approximately 3.2 years. Compensation expense associated with the Tranche B options has been fully recognized as of September 30, 2012.

2010 Long-Term Incentive Plan

On March 19, 2010, our Board of Directors adopted, and our stockholders approved, the Metals USA Holdings 2010 Long-Term Incentive Plan (the 2010 Plan). The purposes of the 2010 Plan are to further the growth and success of the Company and to reward and incentivize the outstanding performance of our key employees, directors, consultants and other service providers by aligning their interests with those of stockholders through equity-based compensation and enhanced opportunities for ownership of shares of our common stock.

Subject to adjustment, the 2010 Plan authorizes the issuance of up to 2.6 million shares of common stock pursuant to the grant or exercise of nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards.

The 2010 Plan is administered by our Board of Directors or the Compensation Committee thereof, or such other committee of the Board of Directors as the Board of Directors may designate from time to time (the Committee). Among other things, the Committee has the authority to select individuals to whom awards may be granted, to determine the type of award, to determine the terms and conditions of any such awards, including vesting terms, to interpret the terms and provisions of the 2010 Plan and awards granted thereunder and to otherwise administer the plan.

Stock Options

September 2010 Grants

On September 13, 2010, pursuant to the 2010 Plan, 632,000 options to acquire the Company s common stock were granted to certain members of our management and to members of our Board of Directors with an exercise price equal to the fair market value as of the date of the grant. The options granted to management vest ratably over four years and have a contractual term of ten years. The options granted to the members of our Board of Directors vest ratably over three years and also have a contractual term of ten years.

As of September 30, 2012, 604,100 of the options granted in September 2010 were outstanding, of which 318,250 were exercisable. The exercise price of these options is $13.17, with an aggregate intrinsic value of $0.1. As of September 30, 2012, these options had approximately $1.4 of total unrecognized compensation expense remaining to be amortized over a weighted average period of approximately 1.7 years, with a weighted average remaining contractual life of approximately 7.8 years.

January 2012 Grants

On January 1, 2012, pursuant to the 2010 Plan, 373,000 options to acquire the Company s common stock were granted to certain members of our management and to members of our Board of Directors with an exercise price equal to the fair market value as of the date of the grant. The options granted to management have an estimated fair value of $6.05 per option, vest ratably over four years from the date of grant and have a contractual term of ten years. The options granted to the members of our Board of Directors have an estimated fair value of $5.50 per option, vest ratably over two years from the date of grant and also have a contractual term of ten years.

The fair value of the January 1, 2012 option awards was estimated on the date of grant using a Black-Scholes option valuation model using the following valuation assumptions:

Expected dividend yield	0%
Expected stock price volatility	64.2%
Risk free interest rate	0.89%
Expected life (in years) management options	5.0
Expected life (in years) Board of Director options	4.0
Exercise price	$ 11.25

As of September 30, 2012, 368,200 of the options granted in January 2012 were outstanding, none of which were exercisable. The exercise price of these options is $11.25, with an aggregate intrinsic value of $0.8. As of September 30, 2012, the options granted in January 2012 had approximately $1.7 of total unrecognized compensation expense remaining to be amortized over a weighted average period of approximately 3.0 years, with a weighted average remaining contractual life of approximately 9.3 years.

Restricted Stock

September 2010 Grants

On September 13, 2010, pursuant to the 2010 Plan, 130,100 shares of restricted stock were granted to certain members of our management and to members of our Board of Directors. The awards granted to management vest ratably over four years, while the awards granted to the members of our Board of Directors vest ratably over three years. The fair value of the restricted stock granted was $13.17 per share, determined based on the fair value of the Company s common stock on the grant date. As of September 30, 2012, approximately $0.7 of total unrecognized compensation expense was expected to be recognized over a weighted average period of approximately 1.6 years.

January 2012 Grants

On January 1, 2012, pursuant to the 2010 Plan, 82,100 shares of restricted stock were granted to certain members of our management and to members of our Board of Directors. The awards granted to management vest ratably over four years from the date of grant, while the awards granted to the members of our Board of Directors vest ratably over two years from the date of grant. The fair value of the restricted stock granted was $11.25 per share, determined based on the fair value of the Company s common stock on the grant date. As of September 30, 2012, approximately $0.7 of total unrecognized compensation expense was expected to be recognized over a weighted average period of approximately 3.0 years.

11. Income Taxes

The provision for income taxes is determined by applying an estimated annual effective income tax rate to income before income taxes, adjusted for any items discrete to the quarter. The annual effective rate is based on the most recent annual forecast of pretax income, permanent book differences and tax credits. The Company s overall effective tax rate for the nine months ended September 30, 2012, and September 30, 2011, is 32.6% and 37.3%, respectively. The decrease in the tax rate in 2012 is primarily due to the impact of state taxes, permanent items, and the resolution of uncertain tax positions, including those resolved due to the lapsing of statutes of limitation, on the respective levels of pre-tax book income.

As of September 30, 2012, our unrecognized tax benefits totaled $5.5. We believe it is reasonably possible that a decrease of up to $1.3 in the consolidated liability for unrecognized tax benefits related to settlements of federal and state tax uncertainties may occur within the next twelve months. In addition, we believe it is reasonably possible that approximately $1.4 of other remaining unrecognized tax benefits, each of which is individually insignificant, may be recognized within the next twelve months as a result of a lapse of the statute of limitations. The total amount of unrecognized tax benefits that, if recognized, would impact the Company s effective tax rate is $3.7 for the nine months ended September 30, 2012.

We file numerous consolidated and separate income tax returns in the United States and Canada. We are no longer subject to U.S. Federal income tax examinations for tax years before 2008, with the exception of the 2005 and 2006 tax years which continue to be open to examination due to the carryback of our 2009 federal net operating loss to those years. We are no longer subject to state, local, or foreign income tax examinations for years before 2006.

We account for any applicable interest and penalties on uncertain tax positions as a component of income tax expense. As of September 30, 2012, the liability for uncertain tax positions includes interest and penalties of $1.4 of which ($1.0) is included in our statement of operations and impacted the Company s overall effective income tax rate for the nine months ended September 30, 2012.

12. Segment Information

The following tables show summarized financial information for our reportable segments. The amounts shown as an operating loss under the column heading Corporate and Other consist primarily of general and administrative costs that are not allocated to the segments. The reconciliation of operating income to income before income taxes is shown within the condensed consolidated statements of operations and comprehensive income and therefore is not separately presented.

	Three Months Ended September 30,				
	Plates and Shapes	Flat Rolled and Non -Ferrous	Building Products	Corporate and Other	Total
2012:					
Net sales	$ 195.6	$ 266.7	$ 23.5	$ (2.1)	$ 483.7
Operating income (loss)	18.1	15.5	1.4	(7.6)	27.4
Capital expenditures	2.8	1.8		0.2	4.8
Depreciation and amortization(1)	2.3	3.4	0.4	0.1	6.2
2011:					
Net sales	$ 191.3	$ 279.7	$ 24.7	$ (3.4)	$ 492.3
Operating income (loss)	20.0	20.6	0.9	(6.2)	35.3
Capital expenditures	1.9	4.5			6.4
Depreciation and amortization(1)	2.4	2.5	0.5	0.1	5.5

	Nine Months Ended September 30,				
	Plates and Shapes	Flat Rolled and Non-Ferrous	Building Products	Corporate and Other	Total
2012:					
Net sales	$ 615.6	$ 875.5	$ 63.8	$ (8.8)	$ 1,546.1
Operating income (loss)	64.6	54.4	0.7	(19.8)	99.9
Capital expenditures	6.4	5.9	0.1	0.9	13.3
Depreciation and amortization(1)	6.9	9.5	1.5	0.3	18.2
2011:					
Net sales	$ 588.1	$ 785.7	$ 66.1	$ (9.7)	$ 1,430.2
Operating income (loss)	67.1	60.8	0.3	(19.8)	108.4
Capital expenditures	4.2	5.6	0.1	0.2	10.1
Depreciation and amortization(1)	7.3	7.5	1.6	0.5	16.9

(1) Includes depreciation expense reflected in cost of goods sold for the Building Products Group.

	September 30, 2012	December 31, 2011
Total Assets:		
Plates and Shapes	$ 377.2	$ 357.1
Flat Rolled and Non-Ferrous	573.1	550.5
Building Products	41.4	39.5
Corporate and Other	37.7	37.7
Consolidated	$ 1,029.4	$ 984.8

Results for the nine months ended September 30, 2012 include operating results from the Gregor acquisition from the date of the acquisition closing. Gregor contributed $6.1 of incremental sales and $0.8 of incremental operating income for the nine months ended September 30, 2012. Acquisition-related costs for the nine months ended September 30, 2012 amounted to approximately $0.6 and are included in selling, general and administrative expenses in the Company s condensed consolidated statement of operations and comprehensive income.

Table of Contents

13. Commitments and Contingencies

Letters of Credit

Letters of credit outstanding at September 30, 2012 consist of letters of credit in the amount of $12.6 in conjunction with the IRBs (see Note 8) and other letters of credit aggregating $7.6 (total letters of credit of $20.2 at September 30, 2012). Other letters of credit consist primarily of collateral support for our property and casualty insurance program. All letters of credit reduce the amount available to borrow under the ABL facility.

Pension Fund Withdrawal Obligation

During 2007, we discontinued our participation in a multiemployer pension fund. In connection with our cessation of contributions to the plan, we were assessed a withdrawal liability of approximately $5.6, which we are paying in monthly installments through 2021. Our total withdrawal liability, including interest and amortization charges, amounted to approximately $5.6 and $6.0 as of September 30, 2012 and December 31, 2011, respectively.

Dividend Policy

On October 22, 2012, our Board of Directors authorized the initiation of a regular annual cash dividend payable on Metals USA Holdings common stock, to be declared and paid quarterly. Our Board of Directors also declared our first regular quarterly cash dividend in the amount of $0.06 per share, to be paid on November 27, 2012 to stockholders of record as of the close of business on November 13, 2012. The declaration and payment of any future dividends will be at the discretion of the Board of Directors, subject to the Company s financial results, cash requirements, and other factors deemed relevant by the Board of Directors. The initiation of this new dividend policy is not a guarantee that a dividend will be declared or paid in any particular period in the future.

Contingencies

From time to time, we are involved in a variety of claims, lawsuits and other disputes arising in the ordinary course of business. We believe the resolution of these matters and the incurrence of their related costs and expenses should not have a material effect on our consolidated financial position, results of operations, cash flows or liquidity.

14. Earnings Per Share

Basic earnings per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period, including the weighted average impact of any shares issued during the year. Diluted earnings per share calculations also include the dilutive effect of stock options and non-vested restricted stock.

The weighted average number of shares used to determine basic and diluted earnings per share was:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2012	**2011**	**2012**	**2011**
Weighted average shares outstanding basic	37,102,523	37,058,507	37,074,748	37,036,187
Effect of dilution:				
Stock options	273,287	280,456	278,176	282,977
Restricted stock	33,524		18,697	1,709

Purchased software	$ 1,636	$ 1,368	$ 268	$ 1,712	$ 1,287	$ 425	4.6 yrs
Purchased licenses	227	227		227	227		2.3 yrs
Trademarks and tradenames	676	386	290	715	357	358	

											7.0 yrs
Business partnerships		110		88		22		116		82	34	5.0 yrs
Customer relationships		3,065		2,216		849		3,177		2,130	1,047	5.3 yrs
	$	5,714	$	4,285	$	1,429	$	5,947	$	4,083	$ 1,864	5.2 yrs

9

Table of Contents

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(1) Changes in intangible gross values as of June 30, 2010 compared to December 31, 2009 are the direct result of changes in foreign currency exchange rates for the periods then ended.

Amortization expense of identifiable intangible assets was $0.2 million for the three months ended June 30, 2010 and 2009 and $0.3 million and $0.4 million for the six months ended June 30, 2010 and 2009, respectively. As Evolving Systems U.K. uses the British Pound Sterling as its functional currency, the amount of future amortization actually recorded will be based upon exchange rates in effect at that time. Expected future amortization expense related to identifiable intangibles based on our carrying amount as of June 30, 2010 was as follows (in thousands):

Twelve months ending June 30,		
2011	$	670
2012		380
2013		379
	$	1,429

NOTE 3 EARNINGS PER COMMON SHARE

We compute basic earnings per share (EPS) by dividing net income or loss available to common stockholders by the weighted average number of shares outstanding during the period, including common stock issuable under participating securities. We compute diluted EPS using the weighted average number of shares outstanding, including participating securities, plus all potentially dilutive common stock equivalents. Common stock equivalents consist of stock options.

We have a policy providing that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities and shall be included in the computation of both basic and diluted earnings per share. Upon adoption of this policy, both basic and diluted income per share for 2009 remained unchanged.

The following is the reconciliation of the denominator of the basic and diluted EPS computations (in thousands):

	Three Months Ended June 30,				**Six Months Ended June 30,**			
		2010		**2009**		**2010**		**2009**
Basic income per common share:								
Net income available to common stockholders	$	1,442	$	1,102	$	2,614	$	2,071
Basic weighted average shares outstanding		10,050		9,777		10,022		9,771
Basic income per common share	$	0.14	$	0.11	$	0.26	$	0.21
Diluted income per common share:								
Net income available to common stockholders	$	1,442	$	1,102	$	2,614	$	2,071
Weighted average common shares outstanding		10,050		9,777		10,022		9,771
Effect of dilutive securities options		703		199		651		141
Diluted weighted average shares outstanding		10,753		9,976		10,673		9,912
Diluted income per common share	$	0.13	$	0.11	$	0.24	$	0.21

For the three months ended June 30, 2010 and 2009, 0.4 million and 1.8 million shares of common stock were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the period.

For the six months ended June 30, 2010 and 2009, 0.4 million and 1.9 million shares of common stock were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the period.

NOTE 4 SHARE-BASED COMPENSATION

We account for stock-based compensation by applying a fair-value-based measurement method to account for share-based payment transactions with employees and directors, and record compensation cost for all stock awards granted after January 1, 2006 and awards modified, repurchased, or cancelled after that date, using the modified prospective method. We record compensation costs associated with the vesting of unvested options on a straight-line basis over the vesting period. We recognized $0.2 million for each of the three months ended June 30, 2010 and 2009 and $0.5 million and $0.4 million for the six month periods ended June 30, 2010 and

Table of Contents

2009, respectively, of compensation expense in the consolidated statements of operations, with respect to our stock-based compensation plans. The following table summarizes stock-based compensation expenses recorded in the consolidated statement of operations (in thousands):

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cost of license fees and services, excluding depreciation and amortization	$ 15	$ 18	$ 28	$ 35
Cost of customer support, excluding depreciation and amortization	5	2	7	4
Sales and marketing	27	35	58	72
General and administrative	173	148	346	271
Product development	29	22	57	44
	$ 249	$ 225	$ 496	$ 426

Stock Incentive Plans

In January 1996, our stockholders approved an Amended and Restated Stock Option Plan (the Option Plan). Under the Option Plan, as amended, and after the reverse stock split, 4,175,000 shares were reserved for issuance. Options issued under the Option Plan were at the discretion of the Board of Directors, including the vesting provisions of each stock option granted. Options were granted with an exercise price equal to the closing price of our common stock on the date of grant, generally vest over four years and expire no more than ten years from the date of grant. The Option Plan terminated on January 18, 2006; options granted before that date were not affected by the plan termination. At June 30, 2010 and December 31, 2009, 1.5 million and 1.7 million options remained outstanding under the Option Plan, respectively.

In March 2007, upon the hiring of our Vice President of World Wide Sales and Marketing, in accordance with NASDAQ Marketplace Rule 4350(i)(1)(a)(iv), the Board of Directors approved an inducement award under a stand-alone equity incentive plan. We granted 50,000 non-qualified options to purchase shares of our common stock at an exercise price equal to the closing price of our common stock on the date of grant. The options vest over four years and expire ten years from the date of grant. At June 30, 2010 and December 31, 2009, 50,000 options remained outstanding under this plan.

In June 2007, our stockholders approved the 2007 Stock Incentive Plan (the 2007 Stock Plan). As a result of the reverse stock split, a maximum of 1,000,000 shares could be issued under the 2007 Stock Plan. In June 2010, our stockholders approved an amendment to the 2007 Stock Plan which increased the maximum shares that may be awarded under the plan to 1,250,000. Awards permitted under the 2007 Stock Plan include: Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Awards and Other Stock-Based Awards. Awards issued under the 2007 Stock Plan are at the discretion of the Board of Directors. As applicable, awards are granted with an exercise price equal to the closing price of our common stock on the date of grant, generally vest over four years for employees and one year for directors and expire no more than ten years from the date of grant. At June 30, 2010, there were approximately 0.2 million shares available for grant under the 2007 Stock Plan, as amended. At June 30, 2010 and December 31, 2009, 0.8 million and 0.6 million options were issued and outstanding under the 2007 Stock Plan, respectively.

During the three and six months ended June 30, 2010, we awarded a total of 0 and 48,750 shares of restricted stock to members of our Board of Directors and senior management. There were no issuances of restricted stock during the three or six months ended June 30, 2009. During the three months ended June 30, 2010 and 2009, 11,000 and 10,000 shares of restricted stock vested, respectively. During the six months ended June 30, 2010 and 2009, 23,000 and 21,000 shares of restricted stock vested, respectively. There were no forfeitures of restricted stock during the three or six months ended June 30, 2010 and 2009. The fair market value for share-based compensation expensing is equal to the closing price of our common stock on the date of grant. Stock-based compensation expense includes $53,000 and $0.1 million for the three and six months ended June 30, 2010, respectively, and $28,000 and $56,000 for the three and six months ended June 30, 2009, respectively, of expense related to restricted stock grants. The restrictions on the stock award are released generally over four years for senior management and over one year for board members.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes model. The Black-Scholes model uses four assumptions to calculate the fair value of each option grant. The expected term of share options granted is derived using the simplified method, which we adopted in January 2008. The risk-free interest rate is based upon the rate currently available on zero-coupon U.S. Treasury instruments with a remaining term equal to the expected term of the stock options. The expected volatility is based upon historical volatility of our common stock over a period equal to the expected term of the stock options. The expected dividend yield is based upon historical and anticipated payment of dividends. The weighted-average assumptions used in the fair value calculations are as follows:

Table of Contents

	Three Months Ended June 30, 2010	2009	Six Months Ended June 30, 2010	2009
Expected term (years)	5.3	5.3	5.9	5.3
Risk-free interest rate	1.9%	2.9%	2.5%	2.4%
Expected volatility	73.9%	76.9%	73.8%	78.0%
Expected dividend yield	2.8%	0%	0.3%	0%

The following is a summary of stock option activity under the plans for the six months ended June 30, 2010:

	Number of Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2009	2,264	$ 5.57		$ 4,304
Options granted	210	$ 6.28		
Less options forfeited	(4)	$ 4.90		
Less options exercised	(119)	$ 4.64		
Options outstanding at June 30, 2010	2,351	$ 5.68	5.25	$ 5,937
Options exercisable at June 30, 2010	1,942	$ 5.90	4.50	$ 4,878

All stock option amounts have been adjusted for the reverse stock split.

The weighted-average grant-date fair value of stock options granted during the three months ended June 30, 2010 and 2009 was $3.72 and $3.07, respectively. The weighted-average grant-date fair value of stock options granted during the six months ended June 30, 2010 and 2009 was $3.89 and $2.20, respectively.

As of June 30, 2010, there was approximately $1.5 million of total unrecognized compensation costs related to unvested stock options. These costs are expected to be recognized over a weighted average period of 2.4 years.

The total fair value of stock options vested during the three months ended June 30, 2010 and 2009 was $0.2 million. The total fair value of stock options vested during the six months ended June 30, 2010 and 2009 was $0.3 million and $0.4 million, respectively.

The deferred income tax benefits from stock option expense related to Evolving Systems U.K. totaled approximately $15,000 for the three months ended June 30, 2010 and 2009. The deferred income tax benefits from stock option expense related to Evolving Systems U.K. totaled approximately $29,000 and $30,000 for the six months ended June 30, 2010 and 2009, respectively.

Cash received from stock option exercises for the three months ended June 30, 2010 and 2009 was $0.4 million and $1,000, respectively. Cash received from stock option exercises for the six months ended June 30, 2010 and 2009 was $0.6 million and $1,000, respectively.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan (ESPP), we were previously authorized to issue up to 1,100,000 shares of our common stock to full-time employees, nearly all of whom are eligible to participate. After the reverse stock split, we are now authorized to issue up to 550,000 shares under the ESPP. Under the terms of the ESPP, employees may elect to have up to 15% of their gross compensation withheld through payroll deduction to purchase our common stock, capped at $25,000 annually and no more than 10,000 shares per offering period. The purchase price of the stock is 85% of the lower of the market price at the beginning or end of each three-month participation period. As of June 30, 2010, there were approximately 83,000 shares available for purchase. For the three months ended June 30, 2010 and 2009, we recorded compensation expense of $3,000 and $6,000, respectively, and $7,000 and $11,000 for each of the six month periods ended June 30, 2010 and 2009, respectively, associated with grants under the ESPP which includes the fair value of the look-back feature of each grant as well as the 15% discount on the purchase price. This expense fluctuates each period primarily based on the level of employee participation.

The fair value of each purchase made under our ESPP is estimated on the date of purchase using the Black-Scholes model. The Black-Scholes model uses four assumptions to calculate the fair value of each purchase. The expected term of each purchase is based

Table of Contents

upon the three-month participation period of each offering. The risk-free interest rate is based upon the rate currently available on zero-coupon U.S. Treasury instruments with a remaining term equal to the expected term of each offering. The expected volatility is based upon historical volatility of our common stock. The expected dividend yield is based upon historical and anticipated payment of dividends. The weighted average assumptions used in the fair value calculations are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Expected term (years)	0.25	0.25	0.25	0.25
Risk-free interest rate	0.2%	0.2%	0.1%	0.2%
Expected volatility	60.2%	66.0%	63.3%	65.6%
Expected dividend yield	0%	0%	0%	0%

Cash received from employee stock plan purchases for the three months ended June 30, 2010 and 2009 was $13,000 and $18,000, respectively. Cash received from employee stock plan purchases for the six months ended June 30, 2010 and 2009 was $28,000 and $33,000, respectively.

We issued shares related to the ESPP of approximately 2,000 and 12,000 for the three months ended June 30, 2010 and 2009, respectively. We issued shares related to the ESPP of approximately 5,000 and 23,000 for the six months ended June 30, 2010 and 2009, respectively.

NOTE 5 CONCENTRATION OF CREDIT RISK

For the three months ended June 30, 2010 and 2009, two significant customers (defined as contributing at least 10%) accounted for 25% (14% and 11%) and 33% (21% and 12%), respectively, of total revenue. For the three months ended June 30, 2010, these customers are a large telecommunications operator in the U.S. and a large telecommunications operator in Indonesia. For the three months ended June 30, 2009, these customers are a large telecommunications operator in the U.S. and a large telecommunications operator in Africa. For the six months ended June 30, 2010, two significant customers accounted for 28% (16% and 12%) of total revenue. These customers are a large telecommunications operator in the U.S. and a large telecommunications operator in Indonesia. For the six months ended June 30, 2009, one significant customer accounted for 24% of total revenue. This customer is a large telecommunications operator located in the U.S.

As of June 30, 2010, one significant customer accounted for approximately 24% of contract receivables and unbilled work-in-progress. This customer is a large telecommunications operator in Indonesia. At December 31, 2009, one significant customer accounted for approximately 38% of contract receivables and unbilled work-in-progress. This customer is a large telecommunications operator located in the U.S.

NOTE 6 LONG-TERM DEBT

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

	June 30, 2010	December 31, 2009
Senior term loan with financial institution, interest at a fixed rate of 8.25%, principal installments and interest payments are due monthly with final maturity on February 22, 2010. The loan is secured by substantially all of our assets.	$	$ 333
$3.5 million U.K. revolving credit facility payable to financial institution, interest at Prime Rate plus 0.5%; interest rate was 3.75% at June 30, 2010 and December 31, 2009. Interest is payable monthly with remaining principal due February 22, 2011. The loan is secured by substantially all of our assets.		1,500
Total debt		1,833
Less current portion		(333)
Long-term debt, excluding current portion	$	$ 1,500

Our $2.5 million U.S. revolving credit facility (U.S. Revolving Facility) bears interest at Prime Rate plus 0.5%. Prime Rate was 3.25% as of June 30, 2010. Borrowings under the revolving facilities are limited to a percentage of our eligible accounts receivable and cash. The U.S. Revolving Facility is secured by all assets of Evolving Systems, Inc. and is subject to certain affirmative and negative

Table of Contents

covenants, including financial covenants related to maintaining a specified ratio of debt to EBITDA, as defined, minimum EBITDA, minimum liquidity, and a specified fixed charge ratio. All accrued interest on outstanding borrowings under the U.S. Revolving Facility is paid monthly, with any outstanding balance due with a final maturity of February 22, 2011. As of June 30, 2010, we had $2.5 million in availability, but no borrowing outstanding under this U.S. Revolving Facility.

Our $3.5 million U.K. Revolving Facility bears interest at Prime Rate plus 0.5%. Prime Rate was 3.25% as of June 30, 2010. Borrowings under the U.K. Revolving Facility are limited to a percentage of our eligible accounts receivable and cash. The U.K. Revolving Facility is secured by all assets of Evolving Systems Holdings Ltd. and Evolving Systems Ltd. and is subject to certain affirmative and negative covenants, including financial covenants related to maintaining a specified ratio of debt to EBITDA, as defined, minimum EBITDA, minimum liquidity, and a specified fixed charge ratio. All accrued interest on outstanding borrowings under the U.K. Revolving Facility is paid monthly, with any outstanding balance due with a final maturity of February 22, 2011. As of June 30, 2010, we had $3.5 million in availability but no borrowings outstanding under this U.K. Revolving Facility.

We were in compliance with all of our debt covenants as of June 30, 2010 and December 31, 2009.

NOTE 7 INCOME TAXES

We recorded net income tax expense of $322,000 and $53,000 for the three months ended June 30, 2010 and 2009, respectively. The net expense during the three months ended June 30, 2010 consisted of income tax expense of $393,000 and a deferred tax benefit of $71,000. The current tax expense consists of income tax from our U.K.-based operations, Alternative Minimum Tax (AMT) and unrecoverable foreign withholding tax in the U.S. and Minimum Alternative Tax (MAT) from our Indian operations. The deferred tax benefit was related to intangible assets from our U.K.-based operations. The net expense during the three months ended June 30, 2009 consisted of income tax expense of $38,000 and a deferred tax expense of $15,000. The income tax expense and the deferred tax expense were primarily related to our U.K.-based operations.

We recorded net income tax expense of $566,000 and $58,000 for the six months ended June 30, 2010 and 2009, respectively. The net expense during the six months ended June 30, 2010 consisted of income tax expense of $692,000 and a deferred tax benefit of $126,000. The current tax expense consists of income tax from our U.K.-based operations, Alternative Minimum Tax (AMT) and unrecoverable foreign withholding tax in the U.S. and Minimum Alternative Tax (MAT) from our Indian operations. The deferred tax benefit was related to intangible assets from our U.K.-based operations. The net expense during the three months ended June 30, 2009 consisted of income tax expense of $94,000 and a deferred tax benefit of $36,000. The income tax expense and the deferred tax expense were primarily related to our U.K.-based operations.

In conjunction with the acquisition of Evolving Systems U.K., we recorded certain identifiable intangible assets. Since the amortization of these identifiable intangibles is not deductible for income tax purposes, we established a long-term deferred tax liability of $4.6 million at the acquisition date for the expected difference between what would be expensed for financial reporting purposes and what would be deductible for income tax purposes. As of June 30, 2010 and December 31, 2009, this component of the deferred tax liability was $0.4 million and $0.5 million, respectively. This deferred tax liability relates to Evolving Systems U.K., and has no impact on our ability to recover U.S.-based deferred tax assets. This deferred tax liability will be recognized as a reduction of deferred income tax expense as the identifiable intangibles are amortized.

As of June 30, 2010 and December 31, 2009 we continued to maintain a full valuation allowance on the domestic net deferred tax asset as we have determined it is more likely than not that we will not realize our domestic deferred tax assets. Such assets primarily consist of certain net operating loss carryforwards. We assessed the realizability of our domestic deferred tax assets using all available evidence. In particular, we considered both historical results and projections of profitability for the reasonably foreseeable future periods. We are required to reassess our conclusions regarding the realization of our deferred tax assets at each financial reporting date. A future evaluation could result in a conclusion that all or a portion of the valuation allowance is no longer necessary, which could have a material impact on our results of operations and financial position.

As of June 30, 2010 and December 31, 2009, we had no liability for unrecognized tax benefits. We do not believe there will be any material changes in our unrecognized tax positions over the next twelve months.

We conduct business globally and, as a result, Evolving Systems, Inc. or one or more of our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business, we are subject to examination by taxing authorities throughout the world, namely the United Kingdom, Germany and India.

NOTE 8 STOCKHOLDERS EQUITY

Common Stock Dividend

Our Board of Directors declared a second quarter cash dividend of $.05 per share, payable July 15, 2010, to stockholders of record June 10, 2010. The dividend was accrued as of June 30, 2010 for $0.5 million and paid on July 15, 2010.

Any determination to declare a future quarterly dividend, as well as the amount of any cash dividend which may be declared, will be based on our financial position, earnings, earnings outlook and other relevant factors at that time.

Table of Contents

Certain Anti-Takeover Provisions/Agreements with Stockholders

Our restated certificate of incorporation allows the board of directors to issue up to 2,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by our stockholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. Issuance of preferred stock, while providing desired flexibility in connection with possible acquisitions and other corporate purposes could make it more difficult for a third party to acquire a majority of our outstanding voting stock. As of June 30, 2010 and December 31, 2009, no shares of Preferred Stock are outstanding.

In addition, we are subject to the anti-takeover provisions of Section 203 of Delaware General Corporation Law which prohibit us from engaging in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in the prescribed manner. The application of Section 203 and certain provisions of our restated certificate of incorporation, including a classified board of directors, may have the effect of delaying or preventing changes in control of our management, which could adversely affect the market price of our common stock by discouraging or preventing takeover attempts that might result in the payment of a premium price to our stockholders.

On March 4, 2009 our Board of Directors adopted a Stockholder Rights Plan (the Rights Agreement) that is designed to strengthen the ability of the Board of Directors to protect Evolving Systems stockholders. The Rights Agreement was not adopted in response to any unsolicited offer or takeover attempt. Under the plan, each common stockholder at the close of business on March 16, 2009 received a dividend of one right for each share of our common stock held of record on that date. Each right will entitle the holder to purchase, in certain circumstances, two one-hundredths of a share of newly-created Series C junior participating preferred stock for an initial purchase price of $8.00 per share. The rights distribution was not taxable to stockholders and the distribution of rights under the plan will not interfere with the Company s business plans or be dilutive to or affect our reported per share results. The rights will generally become exercisable ten business days after any person becomes the beneficial owner of 22.5% (see below for increases to this percentage) or more of our common stock or has commenced a tender or exchange offer which, if consummated, would result in any person becoming the beneficial owner of 22.5% or more of our common stock.

On December 10, 2009, the Board of Directors approved an amendment to the Rights Agreement. The amendment increased, from 22.5% to 25.0%, the percentage of our common stock that a person or group of affiliated or associated persons may beneficially own without triggering the exercisability of the Rights Agreement. All other provisions of the Rights Agreement remain unchanged.

On December 11, 2009, we received a letter from the Singer Trust informing us that as the result of the appointment of John B. Spirtos to our Board of Directors and our approval of the amendment to the Rights Agreement the Singer Trust would vote in favor of the reelection of Philip Neches and Richard Ramlall to our Board of Directors at our 2010 annual meeting of stockholders and the Singer Trust would not seek or otherwise support additional stockholder protections or reforms at the meeting.

On April 20, 2010, our Board of Directors approved an amendment to the Rights Agreement increasing, from 25.0% to 29.0%, the percentage of the our common stock, that a person or group of affiliated or associated persons may beneficially own without triggering the exercisability of the Rights Agreement. All other provisions of the Rights Agreement remain unchanged.

On April 20, 2010, we entered into an agreement with the Singer Trust (the Trust), to increase the size of the Compensation Committee of the Board of Directors from three (3) members to four (4) and, for so long as the Trust is the beneficial holder of twenty percent (20%) or more of our common stock, there would be at least two (2) persons to the Compensation Committee who have been nominated to the Board of Directors by the Trust. We also agreed that all action by the Compensation Committee would require unanimous approval of the members. The Trust agreed that it would vote its shares at the 2010 annual meeting of stockholders in favor of a proposal to amend the Company s 2007 Stock Incentive Plan to provide that, exclusive of shares of Common Stock subject to awards existing as at April 20, 2010 (which shares, when no longer subject to such awards, may not be added to the Plan s share reserve), the total number of shares of Common Stock authorized for issuance under the plan would be 250,000 shares and to provide for certain other amendments. See Part II, Item 4 for results of the 2010 annual meeting of stockholders.

NOTE 9 SEGMENT INFORMATION

We define operating segments as components of our enterprise for which separate financial information is reviewed regularly by the chief operating decision-makers to evaluate performance and to make operating decisions. We have identified our Chief Executive Officer and Chief Financial Officer as our chief operating decision-makers (CODM). These chief operating decision makers review revenues by segment and review overall results of operations.

We currently operate our business as two operating segments based on revenue type: license fees and services revenue and customer support revenue (as shown on the consolidated statements of operations). License fees and services (L&S) revenue represents the fees received from the license of software products and those services directly related to the delivery of the licensed products, such as fees for custom development and integration services. Customer support (CS) revenue includes annual support fees, recurring maintenance fees, fees for maintenance upgrades and warranty services. Warranty services that are similar to software

Table of Contents

maintenance services are typically bundled with a license sale. Total assets by segment have not been disclosed as the information is not available to the chief operating decision-makers.

Segment information is as follows (in thousands):

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenue				
License fees and services	$ 5,668	$ 5,359	$ 11,293	$ 10,104
Customer support	4,081	4,270	8,166	8,368
Total revenue	9,749	9,629	19,459	18,472
Revenue less costs of revenue, excluding depreciation and amortization				
License fees and services	3,707	3,294	7,186	6,362
Customer support	2,931	2,869	5,880	5,534
	6,638	6,163	13,066	11,896
Unallocated Costs				
Other operating expenses	4,429	4,027	9,040	8,042
Depreciation and amortization	317	341	640	668
Interest income	(1)	(18)	(4)	(23)
Interest expense	22	161	61	418
Foreign currency exchange (gain) loss	107	497	149	662
Income before income taxes	$ 1,764	$ 1,155	$ 3,180	$ 2,129

Geographic Regions

We are headquartered in Englewood, a suburb of Denver, Colorado. We use customer locations as the basis for attributing revenues to individual countries. We provide products and services on a global basis through our headquarters and our London-based Evolving Systems U.K. subsidiary. Additionally, personnel in Bangalore, India provide software development services to our global operations. Financial information relating to operations by geographic region is as follows (in thousands):

	Three Months Ended June 30,					
	2010			2009		
	L&S	CS	Total	L&S	CS	Total
Revenue						
United States	$ 739	$ 2,069	$ 2,808	$ 664	$ 2,336	$ 3,000
United Kingdom	877	486	1,363	638	525	1,163
Indonesia	1,005	80	1,085	811	27	838
Other	3,047	1,446	4,493	3,246	1,382	4,628
Total revenues	$ 5,668	$ 4,081	$ 9,749	$ 5,359	$ 4,270	$ 9,629

	Six Months Ended June 30,	
	2010	2009

	L&S	CS	Total	L&S	CS	Total
Revenue						
United States	$ 1,651	$ 4,160	$ 5,811	$ 1,347	$ 4,907	$ 6,254
United Kingdom	1,382	999	2,381	1,325	1,019	2,344
Indonesia	2,194	124	2,318	827	55	882
Other	6,066	2,883	8,949	6,605	2,387	8,992
Total revenues	$ 11,293	$ 8,166	$ 19,459	$ 10,104	$ 8,368	$ 18,472

Table of Contents

	June 30, 2010	December 31, 2009
Long-lived assets, net		
United States	$ 6,642	$ 6,759
United Kingdom	17,177	18,422
Other	210	174
	$ 24,029	$ 25,355

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenue				
Activation	$ 5,529	$ 5,674	$ 11,337	$ 10,516
Numbering solutions	3,686	3,383	7,167	6,771
Mediation	534	572	955	1,185
Total revenues	$ 9,749	$ 9,629	$ 19,459	$ 18,472

NOTE 10 COMMITMENTS AND CONTINGENCIES

(a) Other Commitments

As permitted under Delaware law, we have agreements with officers and directors under which we agree to indemnify them for certain events or occurrences while the officer or director is, or was, serving at our request in this capacity. The term of the indemnification period is indefinite. There is no limit on the amount of future payments we could be required to make under these indemnification agreements; however, we maintain Director and Officer insurance policies, as well as an Employment Practices Liability Insurance Policy, that may enable us to recover a portion of any amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of June 30, 2010 or December 31, 2009.

We enter into standard indemnification terms with customers and suppliers, in the ordinary course of business, for third party claims arising under our contracts. In addition, as we may subcontract the development of deliverables under customer contracts, we could be required to indemnify customers for work performed by subcontractors. Depending upon the nature of the indemnification, the potential amount of future payments we could be required to make under these indemnification agreements may be unlimited. We may be able to recover damages from a subcontractor or other supplier if the indemnification results from the subcontractor s or supplier s failure to perform. To the extent we are unable to recover damages from a subcontractor or other supplier, we could be required to reimburse the indemnified party for the full amount. We have never incurred costs to defend lawsuits or settle claims relating to an indemnification. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of June 30, 2010 or December 31, 2009.

Our standard license agreements contain product warranties that the software will be free of material defects and will operate in accordance with the stated requirements for a limited period of time. The product warranty provisions require us to cure any defects through any reasonable means. We believe the estimated fair value of the product warranty provisions in the license agreements in place with our customers is minimal. Accordingly, there were no liabilities recorded for these product warranty provisions as of June 30, 2010 or December 31, 2009.

Our software arrangements generally include a product indemnification provision whereby we will indemnify and defend a customer in actions brought against the customer for claims that our products infringe upon a copyright, trade secret, or valid patent of a third party. We have not historically incurred any significant costs related to product indemnification claims. Accordingly, there were no liabilities recorded for these indemnification provisions as of June 30, 2010 or December 31, 2009.

In relation to the acquisitions of Evolving Systems U.K., TSE and CMS, we agreed to indemnify certain parties from any losses, actions, claims, damages or liabilities (or actions in respect thereof) resulting from any claim raised by a third party. We do not believe that there will be any claims related to these indemnifications. Accordingly, there were no liabilities recorded for these agreements as of June 30, 2010 or December 31, 2009.

(b) Litigation

We are involved in various legal matters arising in the normal course of business. Losses, including estimated costs to defend, are recorded for these matters to the extent they were probable of loss and the amount of loss could be reasonably estimated.

NOTE 11 RELATED PARTY TRANSACTIONS

Effective October 15, 2009, George A. Hallenbeck resigned from our Board of Directors and we entered into a consulting agreement with him to provide consulting services. Mr. Hallenbeck is one of the founders of the Company. Under the consulting agreement, we will pay Mr. Hallenbeck an annual fee of $10,000 for his services through May 31, 2012. We had current obligations in the consolidated balance sheets under the agreement of $2,500 and $2,000 as of June 30, 2010 and December 31, 2009, respectively.

We recorded approximately $2,500 and $5,000 of general and administrative expense in the consolidated statements of operations, related to this agreement, for the three and six months ended June 30, 2010, respectively.

Effective March 12, 2010, Stephen K. Gartside, Jr., Chairman of the Board, resigned from our Board of Directors We entered into a consulting agreement with Mr. Gartside to provide consulting services to us. Under the consulting agreement we will pay Mr. Gartside a fee of $7,000 for his services through December 31, 2010. We had current obligations in the consolidated balance sheets under the agreement of $2,333 as of June 30, 2010. We recorded approximately $2,333of general and administrative expense in the consolidated statements of operations, related to this agreement, for the three months ended June 30, 2010.

NOTE 12 SUBSEQUENT EVENTS

On August 5, 2010, our Board of Directors declared a third quarter cash dividend of $.05 per share, payable October 15, 2010, to stockholders of record September 10, 2010.

We evaluated our June 30, 2010 financial statements for subsequent events. We are not aware of any additional subsequent events which would require recognition or disclosure in the consolidated financial statements.

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

SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about Evolving Systems industry, management s beliefs, and certain assumptions made by management. Forward-looking statements include our expectations regarding product, services, and maintenance revenue, annual savings associated with the organizational changes effected in prior years, and short- and long-term cash needs. In some cases, words such as anticipates , expects , intends , plans , believes , estimates , variations of these words, and similar expressions are intended to identify forward-looking statements. The statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any forward-looking statements. Risks and uncertainties of our business include those set forth in our Annual Report on Form 10-K for the year ended December 31, 2009 under Item 1A. Risk Factors as well as additional risks described in this Form 10-Q. Unless required by law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

OVERVIEW

We are a leading provider of software solutions and services to the wireless, wireline and cable markets. We maintain long-standing relationships with many of the largest wireless, wireline and cable companies worldwide. Our customers rely on us to develop, deploy, enhance, maintain and integrate complex, reliable software solutions for a range of Operations Support Systems (OSS). Our activation solution is the leading packaged solution for activation in the wireless industry.

We recognize revenue in accordance with the prescribed accounting standards for software revenue recognition under generally accepted accounting principles. Our license fees and services revenues fluctuate from period to period as a result of the timing of revenue recognition on existing projects.

RECENT DEVELOPMENTS

Consolidated revenue increased to $9.7 million and $19.5 million from $9.6 million and $18.5 million for three and six months ended June 30, 2010 and 2009, respectively. This growth is primarily the result of increased revenue from our DSA solution and International *NumeriTrack*.

We reported net income of $1.4 million and $2.6 million for the three and six months ended June 30, 2010, respectively compared to $1.1 million and $2.1 million for the three and six months ended June 30, 2009, respectively. This is the ninth consecutive quarter in which we have reported net income. Our twelve month backlog decreased to $15.8 million as of June 30, 2010, compared to $19.3 million as of June 30, 2009.

We have operations in foreign countries where the local currency is used to prepare the financial statements which are translated into our reporting currency, U.S. Dollars. Changes in the exchange rates between these currencies and our reporting currency are partially responsible for some of the changes from period to period in our financial statement amounts. The chart below summarizes how our revenue and expenses would change had they been reported on a constant currency basis. The constant currency basis assumes that the exchange rate was constant for the periods presented (in thousands).

Table of Contents

	Three Months Ended June 30, 2010 vs. 2009	Six Months Ended June 30, 2010 vs. 2009
	Increase/(Decrease)	
Revenue	$ (186)	$ 57
Costs of revenue and operating expenses	(86)	311
Operating income (loss)	$ (100)	$ (254)

The net effect of our foreign currency translations for the three months ended June 30, 2010 was a $0.2 million decrease in revenue and a $0.1 million decrease in operating expenses versus the three months ended June 30, 2009. The net effect of our foreign currency translations for the six months ended June 30, 2010 was a $0.1 million increase in revenue and a $0.3 million increase in operating expenses versus the six months ended June 30, 2009.

RESULTS OF OPERATIONS

The following table presents the unaudited consolidated statements of operations reflected as a percentage of total revenue.

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
REVENUE				
License fees and services	58%	56%	58%	55%
Customer support	42%	44%	42%	45%
Total revenue	100%	100%	100%	100%
COSTS OF REVENUE AND OPERATING EXPENSES				
Costs of license fees and services, excluding depreciation and amortization	20%	21%	21%	20%
Costs of customer support, excluding depreciation and amortization	12%	15%	11%	15%
Sales and marketing	19%	20%	19%	21%
General and administrative	14%	14%	15%	15%
Product development	11%	7%	12%	8%
Depreciation	2%	2%	2%	2%
Amortization	2%	2%	2%	2%
Total costs of revenue and operating expenses	80%	81%	82%	83%
Income from operations	20%	19%	18%	17%
Other income (expense)				
Interest income	0%	0%	0%	0%
Interest expense	(0)%	(2)%	(0)%	(2)%
Foreign currency exchange loss	(1)%	(5)%	(1)%	(4)%
Other income (expense), net	(1)%	(7)%	(1)%	(6)%
Income before income taxes	19%	12%	17%	11%
Income tax expense	3%	1%	3%	0%

Net income	16%	11%	14%	11%

Revenue

Revenue is comprised of license fees/services and customer support. License fees and services revenue represent the fees we receive from the licensing of our software products and those services directly related to the delivery of the licensed product as well as integration and consulting services. Customer support revenue includes annual support, recurring maintenance, maintenance upgrades and warranty services. Warranty services consist of maintenance services and are typically bundled with a license sale and the related

Table of Contents

revenue, based on Vendor-Specific Objective Evidence (VSOE), and is deferred and recognized ratably over the warranty period. The following table presents our revenue by product group (in thousands):

	Three Months Ended June 30, 2010		Three Months Ended June 30, 2009		Six Months Ended June 30, 2010		Six Months Ended June 30, 2009
Revenue							
Activation	$	5,529	$	5,674	$	11,337	$	10,516
Numbering solutions		3,686		3,383		7,167		6,771
Mediation		534		572		955		1,185
Total revenues	$	9,749	$	9,629	$	19,459	$	18,472

Revenue for the three months ended June 30, 2010 and 2009 was $9.7 million and $9.6 million, respectively. Revenue for the six months ended June 30, 2010 and 2009 was $19.5 million and $18.5 million, respectively. Increased revenue in both periods is primarily due to increased revenue from our *Dynamic SIM AllocationTM* (DSA) and International *NumeriTrack* products partially offset by decreased sales related to our Tertio service activation products.

License Fees and Services

License fees and services revenue increased $0.3 million, or 6%, to $5.7 million for the three months ended June 30, 2010 from $5.4 million for the three months ended June 30, 2009. Changes in license fees and services revenue for the three months ended June 30, 2010 compared to the three months ended June 30, 2009 included an increase of $0.3 million in revenue from our numbering solutions products, an increase of $0.2 million in revenue from our mediation products and a decrease of $0.2 million in revenue from our activation products. This growth in our numbering solutions and mediation product groups is due to increased revenue from International *NumeriTrack* and our legacy numbering and mediation products. The decrease in revenue from our activation products is due to decreased sales of our Tertio service activation products, partially offset by increased revenue from DSA.

License fees and services revenue increased $1.2 million, or 12%, to $11.3 million for the six months ended June 30, 2010 from $10.1 million for the six months ended June 30, 2009. Changes in license fees and services revenue for the six months ended June 30, 2010 compared to the six months ended June 30, 2009 included an increase of $0.6 million in revenue from our numbering solutions products, an increase of $0.3 million in revenue from our mediation products and an increase of $0.3 million in revenue from our activation products. This growth in the product groups is primarily due to increased revenue from International *NumeriTrack* and our legacy numbering and mediation products partially offset by a decrease in revenue from our Tertio service activation products.

Customer Support

Customer support revenue decreased $0.2 million, or 4%, to $4.1 million for the three months ended June 30, 2010 from $4.3 million for the three months ended June 30, 2009. Changes in customer support revenue for the three months ended June 30, 2010 compared to the three months ended June 30, 2009 included a decrease in revenue from our mediation products of $0.3 million partially offset by an increase of $0.1 million in revenue from our activation products. The growth in customer support for our activation products is due to increased revenue from DSA. The decrease in revenue from our mediation products is due to support contracts that were not renewed by customers.

Customer support revenue decreased $0.2 million, or 2%, to $8.2 million for the six months ended June 30, 2010 from $8.4 million for the six months ended June 30, 2009. Changes in customer support revenue for the six months ended June 30, 2010 compared to the six months ended June 30, 2009 included a decrease in revenue from our mediation products of $0.5 million and our numbering solutions products of $0.2 million, partially offset by an increase of $0.5 million in revenue from our activation products. The growth in customer support for our activation product group is due to increased revenue from DSA. The decrease in revenue from our mediation products is due to support contracts that were not renewed by customers.

Costs of Revenue, Excluding Depreciation and Amortization

Costs of revenue, excluding depreciation and amortization, consist primarily of personnel costs and other direct costs associated with these personnel, facilities costs, costs of third-party software and partner commissions. Costs of revenue, excluding depreciation and amortization, were $3.1 million and $3.5 million for the three months ended June 30, 2010 and 2009, respectively. Costs of revenue, excluding depreciation and amortization, were $6.4 million and $6.6 million for the six months ended June 30, 2010 and 2009, respectively.

Costs of License Fees and Services, Excluding Depreciation and Amortization

Costs of license fees and services, excluding depreciation and amortization, decreased $0.1 million, or 5%, to $2.0 million for the three months ended June 30, 2010 from $2.1 million for the three months ended June 30, 2009. As a percentage of license fees and services revenue, costs of license fees and services, excluding depreciation and amortization, decreased to 35% for the three months ended June 30, 2010 from 39% for the three months ended June 30, 2009. The decrease in costs and as a percentage of revenue is primarily the result of higher revenue during the period, lower partner commissions and lower occupancy costs related to new office leases at our U.K. and India offices, partially offset by higher travel expenses from increased onsite involvement from our DSA implementation team.

Costs of license fees and services, excluding depreciation and amortization, increased $0.4 million, or 10%, to $4.1 million for the six months ended June 30, 2010 from $3.7 million for the six months ended June 30, 2009. The increase in costs is primarily the result of increased labor costs to support higher revenue and higher travel expenses from increased onsite involvement from our DSA implementation team, partially offset by lower partner commissions and lower occupancy costs related to new office leases at our U.K. and India offices. As a percentage of license fees and services revenue, costs of license fees and services, excluding depreciation and amortization, decreased to 36% for the six months ended June 30, 2010 from 37% for the six months ended June 30, 2009. The decrease in costs and as a percentage of revenue is primarily the result of higher revenue during the period partially offset by the aforementioned increased costs during the period.

Costs of Customer Support, Excluding Depreciation and Amortization

Costs of customer support, excluding depreciation and amortization, decreased $0.2 million, or 18%, to $1.2 million for the three months ended June 30, 2010 from $1.4 million for the three months ended June 30, 2009. As a percentage of customer support revenue, costs of customer support revenue, excluding depreciation and amortization, decreased to 28% for the three months ended June 30, 2010 from 33% for the three months ended June 30, 2009. The decrease in costs of customer support and the decrease as a percentage of revenue are primarily the result of our increased reliance on our lower cost India work force.

Costs of customer support, excluding depreciation and amortization, decreased $0.5 million, or 19%, to $2.3 million for the six months ended June 30, 2010 from $2.8 million for the three months ended June 30, 2009. As a percentage of customer support revenue, costs of customer support revenue, excluding depreciation and amortization, decreased to 28% for the six months ended June 30, 2010 from 34% for the six months ended June 30, 2009. The decrease in costs of customer support and as a percentage of revenue, are primarily the result of our increased reliance on our lower cost India work force.

Sales and Marketing

Sales and marketing expenses primarily consist of compensation costs, including incentive compensation and commissions, travel expenses, advertising, marketing and facilities expenses. Sales and marketing expenses remained at $1.9 million for the three months ended June 30, 2010 and 2009. As a percentage of total revenue, sales and marketing expenses decreased to 19% for the three months ended June 30, 2010 from 20% for the three months ended June 30, 2009. The decrease as a percentage of revenue is primarily due to increased revenue during the period.

Sales and marketing expenses remained at $3.8 million for the six months ended June 30, 2010 and 2009. As a percentage of total revenue, sales and marketing expenses decreased to 19% for the six months ended June 30, 2010 from 21% for the six months ended June 30, 2009. The decrease as a percentage of revenue is primarily due to increased revenue during the period.

General and Administrative

General and administrative expenses consist principally of employee related costs and professional fees for the following departments: facilities, finance, legal, human resources, and certain executive management. General and administrative expenses increased $0.1 million, or 4%, to $1.5 million from $1.4 million for the three months ended June 30, 2010 and 2009, respectively. The increase in costs is primarily due to increased equity compensation expenses related to the increased price of our common stock. As a percentage of total revenue, general and administrative expenses for the three months ended June 30, 2010 and 2009 remained at 14%.

General and administrative expenses increased $0.1 million, or 4%, to $2.9 million from $2.8 million for the six months ended June 30, 2010 and 2009, respectively. The increase in costs is primarily due to increased equity compensation expenses related to the increased price of our common stock. As a percentage of total revenue, general and administrative expenses for the three months ended June 30, 2010 and 2009 remained at 15%.

Product Development

Product development expenses consist primarily of employee related costs and subcontractor expenses. Product development expenses increased $0.4 million, or 63%, to $1.1 million from $0.7 million for the three months ended June 30, 2010 and 2009, respectively. As a percentage of revenue, product development expenses for the three months ended June 30, 2010 and 2009, increased to 11% from 7%, respectively. The increase in expenses and as a percentage of revenue is primarily due to an increased development effort on our DSA product and new features on our legacy numbering products.

Product development expenses increased $0.9 million, or 69%, to $2.3 million from $1.4 million for the six months ended June 30, 2010 and 2009, respectively. As a percentage of revenue, product development expenses for the six months ended June 30, 2010 and 2009, increased to 12% from 8%, respectively. The increase in expenses and as a percentage of revenue is primarily due to an increased development effort on our DSA product and new features on our legacy numbering products.

Table of Contents

Depreciation

Depreciation expense consists of depreciation of long-lived property and equipment. Depreciation expense remained at $0.2 million for the three months ended June 30, 2010 and 2009. As a percentage of total revenue, depreciation expense for the three months ended June 30, 2010 and 2009 remained at 2%.

Depreciation expense remained at $0.3 million for the six months ended June 30, 2010 and 2009. As a percentage of total revenue, depreciation expense for the six months ended June 30, 2010 and 2009 remained at 2%.

Amortization

Amortization expense consists of amortization of identifiable intangible assets acquired through our acquisitions of Evolving Systems U.K., TSE and CMS. Amortization expense remained at $0.2 million for the three months ended June 30, 2010 and 2009. As a percentage of revenue, amortization expense for the three months ended June 30, 2010 and 2009 remained at 2%. Amortization expense remained at $0.3 million for the six months ended June 30, 2010 and 2009. As a percentage of revenue, amortization expense for the three months ended June 30, 2010 and 2009 remained at 2%.

Interest Expense

Interest expense includes interest expense on our long-term debt and capital lease obligations as well as amortization of debt issuance costs. Interest expense was $22,000 and $161,000 for the three months ended June 30, 2010 and 2009, respectively. The decrease of $139,000 is due to the retirement of our subordinated debt during 2009 and the retirement of our senior term loan.

Interest expense was $61,000 and $0.4 million for the six months ended June 30, 2010 and 2009, respectively. The decrease of $0.4 million is due to the retirement of our subordinated debt during 2009 and the retirement of our senior term loan.

Foreign Currency Exchange Gain (Loss)

Foreign currency transaction gains (losses) resulted from transactions denominated in a currency other than the functional currency of the respective subsidiary and were ($0.1) million and ($0.5) million for the three months ended June 30, 2010 and 2009, respectively and $(0.1) million and ($0.7) million for the six months ended June 30, 2010 and 2009, respectively. The gains (losses) were generated primarily through the re-measurement of certain non-functional currency denominated financial assets and liabilities of our Evolving Systems U.K. and India subsidiaries.

Income Taxes

We recorded net income tax expense of $322,000 and $53,000 for the three months ended June 30, 2010 and 2009, respectively. The net expense during the three months ended June 30, 2010 consisted of income tax expense of $393,000 and a deferred tax benefit of $71,000. The current tax expense consists of income tax from our U.K.-based operations, Alternative Minimum Tax (AMT) and unrecoverable foreign withholding tax in the U.S. and Minimum Alternative Tax (MAT) from our Indian operations. The deferred tax benefit was related to intangible assets from our U.K.-based operations. The net expense during the three months ended June 30, 2009 consisted of income tax expense of $38,000 and a deferred tax expense of $15,000. The income tax expense and the deferred tax expense were primarily related to our U.K.-based operations. Our effective tax rate of 18% for the three months ended June 30, 2010 was up from an effective rate of 5% for the three months ended June 30, 2009. This increase in our effective tax rate relates principally to increased earnings in the U.K., which has the highest tax rate of all of our jurisdictions and reflects a more normalized rate of expected income tax expense. Our current effective tax rate of 18% includes the utilization of our U.S. net operating losses.

We recorded net income tax expense of $566,000 and $58,000 for the six months ended June 30, 2010 and 2009, respectively. The net expense during the six months ended June 30, 2010 consisted of income tax expense of $692,000 and a deferred tax benefit of $126,000. The current tax expense consists of income tax from our U.K.-based operations, Alternative Minimum Tax (AMT) and unrecoverable foreign withholding tax in the U.S. and Minimum Alternative Tax (MAT) from our Indian operations. The deferred tax benefit was related to intangible assets from our U.K.-based operations. The net expense during the three months ended June 30, 2009 consisted of income tax expense of $94,000 and a deferred tax benefit of $36,000. The income tax expense and the deferred tax benefit were primarily related to our U.K.-based operations. Our effective tax rate of 18% for the six months ended June 30, 2010 was up from an effective rate of 3% for the six months ended June 30, 2009. This increase in our effective tax rate relates principally to increased earnings in the U.K., which has the highest tax rate of all of our jurisdictions and reflects a more normalized rate of expected income tax expense. Our current effective tax rate of 18% includes the utilization of our U.S. net operating losses.

In conjunction with the acquisition of Evolving Systems U.K., we recorded certain identifiable intangible assets. Since the amortization of these identifiable intangibles is not deductible for income tax purposes, we established a long-term deferred tax liability of $4.6 million at the acquisition date for the expected difference between what would be expensed for financial reporting purposes and what would be deductible for income tax purposes. As of June 30, 2010 and December 31, 2009, this component of the deferred tax liability was $0.4 million and $0.5 million, respectively. This deferred tax liability relates to Evolving Systems U.K., and has no impact on our ability to recover U.S.-based deferred tax assets. This deferred tax liability will be recognized as a reduction of deferred income tax expense as the identifiable intangibles are amortized.

Table of Contents

FINANCIAL CONDITION

Our working capital position increased $1.9 million to $6.7 million as of June 30, 2010 from $4.8 million as of December 31, 2009.

CONTRACTUAL OBLIGATIONS

During the second quarter we renewed our office lease at our London, England location and reduced the size of our facility. The new leased space consists of 2,765 square feet and expires March 24, 2015.

There have been no other material changes to the contractual obligations as disclosed in our 2009 Annual Report on Form 10-K.

LIQUIDITY AND CAPITAL RESOURCES

We have historically financed operations through cash flows from operations and equity transactions. At June 30, 2010, our principal source of liquidity was $9.2 million in cash and cash equivalents, $4.5 million in contract receivables, net of allowance, as well as $6.0 million available under our revolving credit facilities.

Net cash provided by operating activities for the six months ended June 30, 2010 and 2009 was $5.4 million and $1.6 million, respectively. The increase in cash provided by operating activities for the six months ended June 30, 2010 was due primarily to improved financial results, the timing of billings and collections and during the six months ended June 30, 2009 we paid $1.2 million of accrued interest on our subordinated debt.

Net cash used in investing activities during each of the six months ended June 30, 2010 and 2009 was $0.3 million. The cash used for the six months ended June 30, 2010 and 2009 was related to purchases of property and equipment.

Net cash used in financing activities for the six months ended June 30, 2010 and 2009 was $1.2 million and $2.5 million, respectively. The decrease in cash used in financing activities is due to the retirement of our senior and subordinated debt, on which we paid less during 2010 and increased cash in from the exercise of stock options.

We believe that our current cash and cash equivalents, together with anticipated cash flow from operations and availability under our revolving line of credit will be sufficient to meet our working capital, capital expenditure and financing requirements for at least the next twelve months. In making this assessment we considered the following:

- Our cash and cash equivalents balance at June 30, 2010 of $9.2 million;
- The availability under our revolving credit facilities of $6.0 million at June 30, 2010;
- Our working capital balance of $6.7 million;
- Our demonstrated ability to generate positive cash flows from operations;
- The declaration of our third quarter cash dividend of $.05 per share and the possibility of future dividends;
- Our backlog as of June 30, 2010 of approximately $15.8 million, including $6.0 million in license fees and services and $9.8 million in customer support.

We are exposed to foreign currency rate risks which impact the carrying amount of our foreign subsidiaries and our consolidated equity, as well as our consolidated cash position due to translation adjustments. For the six months ended June 30, 2010, the effect of exchange rate changes resulted in a $0.1 million decrease to consolidated cash. During the six months ended June 30, 2009, the effect of exchange rate changes resulted in a $0.4 million increase in consolidated cash. We do not currently hedge our foreign currency exposure, but we monitor rate changes and may hedge our exposures if we see significant negative trends in exchange rates.

OFF-BALANCE SHEET ARRANGEMENTS

We have no off-balance sheet arrangements that have a material current effect or that are reasonably likely to have a material future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

ITEM 3. QUANTITATIVE AND QUALITATIVE MARKET RISK DISCLOSURES

In the ordinary course of business, we are exposed to certain market risks, including changes in interest rates and foreign currency exchange rates. Uncertainties that are either non-financial or non-quantifiable such as political, economic, tax, other regulatory, or credit risks are not included in the following assessment of market risks.

Table of Contents

Interest Rate Risks

Our cash balances are subject to interest rate fluctuations and as a result, interest income amounts may fluctuate from current levels. We could be exposed to interest rate risk related to our senior revolving credit facilities entered into in February 2008. These obligations are variable interest rate notes based on Prime Rate. Fluctuations in Prime Rate affect our interest rates. There was no balance outstanding on our credit facilities as of June 30, 2010. As of December 31, 2009, there was $1.5 million outstanding on our senior revolving credit facilities.

Foreign Currency Risk

We are exposed to favorable and unfavorable fluctuations of the U.S. dollar (our functional currency) against the currencies of our operating subsidiaries. Any increase (decrease) in the value of the U.S. dollar against any foreign currency that is the functional currency of one of our operating subsidiaries will cause the parent company to experience unrealized foreign currency translation losses (gains) with respect to amounts already invested in such foreign currencies. In addition, we and our operating subsidiaries are exposed to foreign currency risk to the extent that we enter into transactions denominated in currencies other than our respective functional currencies, such as accounts receivable (including intercompany amounts) that are denominated in a currency other than their own functional currency. Changes in exchange rates with respect to these items will result in unrealized (based upon period-end exchange rates) or realized foreign currency transaction gains and losses upon settlement of the transactions. In addition, we are exposed to foreign exchange rate fluctuations related to our operating subsidiaries monetary assets and liabilities and the financial results of foreign subsidiaries and affiliates when their respective financial statements are translated into U.S. dollars for inclusion in our consolidated financial statements. Cumulative translation adjustments are recorded in accumulated other comprehensive income (loss) as a separate component of equity. As a result of foreign currency risk, we may experience economic loss and a negative impact on earnings and equity with respect to our holdings solely as a result of foreign currency exchange rate fluctuations.

The relationship between the British Pound Sterling, Indian rupee and the U.S. dollar, which is our functional currency, is shown below, per one U.S. dollar:

Spot rates:	**June 30, 2010**	**December 31, 2009**
Great British pound	0.66370	0.62792
Indian rupee	46.48160	46.75082

	Three Months Ended June 30,		**Six Months Ended June 30,**	
Average rates:	**2010**	**2009**	**2010**	**2009**
Great British pound	0.67092	0.64756	0.65616	0.67168
Indian rupee	45.72305	49.28691	45.87865	49.89934

At the present time, we do not hedge our foreign currency exposure or use derivative financial instruments that are designed to reduce our long-term exposure to foreign currency exchange risk. To the extent that translation and transaction gain and losses become significant, we will consider various options to reduce this risk.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission 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.

Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of such period.

In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Table of Contents

During the three months ended June 30, 2010, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) or in other factors that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various legal matters arising in the normal course of business. Losses, including estimated costs to defend, are recorded for these matters to the extent they were probable of loss and the amount of loss could be reasonably estimated.

ITEM 1A. RISK FACTORS

During the second and third quarter of 2010, our Board of Directors declared a cash dividend of $.05 per share. The decision to pay dividends in the future will depend on general business conditions, the impact of such payment on our financial condition and other factors our Board of Directors may consider to be relevant. In addition, since our revolving credit facility currently prohibits us from declaring dividends to our common stockholders, any future dividend payments would need to be approved, in the same manner as our prior dividends, by the financial institution which issued our revolving credit facility. If we elect to pay future dividends, this could reduce our cash reserves to levels that may be inadequate to fund expansions to our business plan or unanticipated contingent liabilities.

This Quarterly Report on Form 10-Q should be read in conjunction with the risk factors defined in our Annual Report on Form 10-K for the year ended December 31, 2009 under Item 1A. Risk Factors.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We held our Annual Meeting of Stockholders on June 16, 2010. According to the final vote tally received from the Company s transfer agent, the results of the voting on Proposals 1, 2 and 3, as described in the Company s Proxy Statement, were as follows:

Proposal #1: Election of Directors

Phillip M. Neches was re-elected to serve a three-year term until 2013.

For 5,839,906

Withheld 78,612

Richard R. Ramlall was re-elected to serve a three-year term until 2013.

For 5,906,648

Withheld 11,870

Proposal #2: Approval of the Amendment to our 2007 Stock Incentive Plan to increase the number of shares of common stock authorized for issuance under the plan by 250,000 shares and to provide certain other amendments

For 5,700,882

Against 212,807

Abstain 4,829

Broker Non-Votes 3,011,043

Proposal #3: Ratification of Independent Registered Public Accounting Firm

Grant Thornton LLP was ratified as the independent registered public accounting firm for the year ending December 31, 2010.

For 8,820,747

Against 102,799

Abstain 6,015

Table of Contents

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

(a) Exhibits

Exhibit 10.23 Agreement entered into with Singer Children s Management Trust, as filed as Exhibit 10.1 to the Company s Form 8-K filed April 20, 2010 and incorporated herein by reference

Exhibit 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURE

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

Date: August 5, 2010	/s/ BRIAN R. ERVINE Brian R. Ervine Executive Vice President, Chief Financial and Administrative Officer, Treasurer and Assistant Secretary (Principal Financial and Accounting Officer)