

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

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

FORM 10-Q/A  
Amendment No. 1

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

☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 0-22496

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

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

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

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

**97296-0047**  
(Zip Code)

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

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

Yes ☐ No ☒

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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

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

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SCHNITZER STEEL INDUSTRIES, INC.

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EXPLANATORY NOTE

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Note 1 - Restatement:**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

|                       |    |        |    |   |    |        |
|-----------------------|----|--------|----|---|----|--------|
| Cash at end of period | \$ | 17,271 | \$ | — | \$ | 17,271 |
|-----------------------|----|--------|----|---|----|--------|

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

*Basis of Presentation*

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

*Reclassifications*

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

*Cash and Cash Equivalents*

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

*Net Income and Dividends per Share*

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

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

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

Goodwill and Intangible Assets

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

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

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

Foreign Currency Transactions

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

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

New Accounting Pronouncements

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

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

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

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

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

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**Note 3 - Inventories:**

Inventories consisted of the following (in thousands):

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

**Note 4 - Business Combinations:**

*Hugo Neu Corporation Separation and Termination Agreement*

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

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

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

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

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

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

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

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

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

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

GreenLeaf Acquisition

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

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

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

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

Regional Recycling Acquisition

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

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

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

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

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

Summary of Acquisitions

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

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

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

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

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

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

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

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

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

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

#### **Metals Recycling Business**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### **Auto Parts Business**

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

#### **Other Contingencies**

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



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**Note 6 - Long Term Debt:**

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

**Note 7 - Related Party Transactions:**

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

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

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



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**Note 8 - Stock Incentive Plan:**

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

*Stock Options*

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

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

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

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

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

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

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

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

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

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

Long-Term Incentive Plan (LTIP)

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

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

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

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

**Note 9 - Employee Benefits:**

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

Primary actuarial assumptions are determined as follows:

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

**Defined Benefit Pension Plan**

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

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

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



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Defined Contribution Plans

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

|            | For the Three Months Ended<br>February 28, |        | For the Six Months Ended<br>February 28, |        |
|------------|--------------------------------------------|--------|------------------------------------------|--------|
|            | 2006                                       | 2005   | 2006                                     | 2005   |
| Plan costs | \$ 192                                     | \$ 190 | \$ 992                                   | \$ 536 |

Multiemployer Pension Plans

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

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

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

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

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

**Note 10 - Segment Information:**

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

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

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

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

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

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

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

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

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

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



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**Note 11 - Subsequent Events:**

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

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

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

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

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

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

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



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

**Restatement**

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

**General**

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

*Metals Recycling Business*

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

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

SCHNITZER STEEL INDUSTRIES, INC.

Auto Parts Business

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

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

Steel Manufacturing Business

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

**Acquisitions and Transactions**

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

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

SCHNITZER STEEL INDUSTRIES, INC.

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

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

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

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

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

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

## SCHNITZER STEEL INDUSTRIES, INC.

**Results of Operations**

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

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

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

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

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



## SCHNITZER STEEL INDUSTRIES, INC.

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

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

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

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

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



SCHNITZER STEEL INDUSTRIES, INC.

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

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

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

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

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

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



SCHNITZER STEEL INDUSTRIES, INC.

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

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

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

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

Revenue from the Metals Recycling Business' nonferrous metal sales increased \$37.4 million, or 220%, over the prior year second quarter, which resulted from a \$0.20, or 37%, increase in average net sales price to \$0.74 per pound which was a result of the strong nonferrous markets and from an increase in shipments of 40.9 million pounds, or 132%. Total nonferrous shipped for the second fiscal quarter of 2006 was 71.8 million pounds. The increase in sales price per pound was primarily a result of the increased Asian demand for nonferrous metals and partially due to the Regional acquisition, as Regional's recycling operations produce a more valuable mix of nonferrous metals. The increase in pounds shipped was primarily due to the acquired businesses, which accounted for an additional 38.3 million pounds sold in the second quarter of fiscal 2006. Certain nonferrous metals are a byproduct of the shredding process, and quantities available for shipment are affected by the volume of materials processed in the Company's shredders.

The Auto Parts Business generated revenues of \$50.0 million, before intercompany eliminations, for the quarter ended February 28, 2006, an increase of \$25.5 million, or 104%, over the same period of the prior year. This increase in revenues was primarily due to the acquisition of GreenLeaf in September 2005, as well as the addition of four self-service stores in January 2005.

## SCHNITZER STEEL INDUSTRIES, INC.

The Steel Manufacturing Business generated revenues of \$89.5 million for the quarter ended February 28, 2006, an increase of \$22.7 million, or 34%, over the prior year quarter. Sales volumes in the second fiscal quarter of 2006 reached 165,000 tons, an increase of 32% over the same period last year; increasing revenues by \$20.7 million, primarily due to strong demand for rebar products. Additionally, during the second quarter of fiscal 2005, customers reduced purchases of steel in an effort to reduce inventories on hand. By contrast, during the first quarter of fiscal 2006, customers were buying steel to replace inventories, and consumption of steel was strong. The average net selling price increased \$5 per ton, or 1%, to \$522 per ton, which resulted in increased revenue of \$0.8 million. The average net selling price rose because of price increases in December for merchant bar and wire rod products and a stronger mix of rebar products.

**Cost of Goods Sold.** Consolidated cost of goods sold increased \$183.5 million, or 118%, for the quarter ended February 28, 2006, compared with the same period last year. Cost of goods sold increased as a percentage of revenues from 72% to 84%.

Cost of goods sold for the Metals Recycling Business increased \$156.8 million, or 145%, to \$265.3 million compared to the second fiscal quarter of 2005. As a percentage of revenues, cost of goods sold increased compared with the prior year quarter from 71% to 90%. The increase in cost of goods sold was primarily attributable to the businesses acquired through the HNC separation and termination, as these businesses have been experiencing narrower margins than the Company's historical West Coast business. The margin variations for these businesses are due, in part, to more competitive markets for materials in the Northeast region, higher operating expenses due to outdated and inefficient equipment, higher freight costs to access certain foreign markets, and the lower margins generally inherent in the Schnitzer Global Exchange trading business. The Company has begun a major capital improvement program to upgrade infrastructure and equipment in the Northeast and throughout the Company to become more efficient and improve productivity. While Schnitzer Global Exchange, the Company's new trading business, provides increased revenues, the associated trading margins are lower than the historical Metals Recycling Business. Although the Company attempts to maintain and grow margins by responding to changing recycled metals selling prices through adjustments to its metals purchase prices, the Company's ability to do so in the trading business is particularly limited by competitive and other market factors.

Cost of goods sold for the Auto Parts Business increased \$19.8 million, or 138%, compared to the fiscal 2005 second quarter. As a percentage of revenues, cost of goods sold increased compared with the prior year quarter from 59% to 68%. The higher cost of goods sold was primarily due to the acquisition of GreenLeaf in September 2005 and four self-service stores in January 2005. Cost of goods sold also increased due to strong demand for unprocessed metals that resulted in higher car purchase costs, and because GreenLeaf typically purchases newer vehicles, resulting in a higher purchase price and lower margins as compared to the older model vehicles that Pick-N-Pull purchases. During the quarter, the operations acquired in the GreenLeaf transaction recorded an operating loss as the Company continued the process of integrating GreenLeaf's operations into Pick-N-Pull's operations.

Cost of goods sold for the Steel Manufacturing Business increased \$11.5 million, or 19%, as compared to the fiscal 2005 second quarter. The overall increase in cost of goods sold was primarily caused by a 32% increase in sales volume. As a percentage of revenues, cost of goods sold declined compared with the prior year quarter from 91% to 81%. The Steel Manufacturing Business continues to see the benefits from the new furnace installed at its mini-mill last year, production incentives recently negotiated with the steelworkers union and other improvements in business practices, which has all contributed to reducing the cost of goods sold per ton. As a result of the increased production volumes, lower cost per ton of producing steel and lower average costs for raw materials purchased, along with the increase in the average sales price.

## SCHNITZER STEEL INDUSTRIES, INC.

**Selling, General and Administrative Expense.** Compared with the second quarter of fiscal 2005, selling, general and administrative expense for the same quarter this fiscal year increased \$20.4 million, or 155%, to \$33.5 million. As a percentage of revenues, selling, general and administrative expense increased by 2%, from 6% to 8%. A significant portion of the increase, \$13.3 million, was attributed to the acquisitions that took place in the first quarter of fiscal 2006. Additionally, compensation costs increased approximately \$2.0 million as the Company's infrastructure has grown to accommodate these acquisitions. The Company incurred higher legal, accounting and professional fees of \$1.3 million, including a \$1.0 million increase in legal expenses related to the Audit Committee's investigation of past payment practices in Asia as discussed in Note 5 to the condensed consolidated financial statements. The adoption of FAS 123(R) in fiscal 2006 resulted in stock-based compensation expense of \$1.1 million for the quarter. The Company also recognized compensation costs of \$0.5 million for awards under its long-term incentive plan approved in fiscal 2006 as discussed in Note 8 to the condensed consolidated financial statements.

**Environmental Matter.** The Company did not incur any environmental matter charges during the second quarter of fiscal 2006. During the second quarter of fiscal 2005, the Company recorded environmental charges of \$7.7 million for additional estimated costs related to the ongoing remediation of the head of the Hylebos Waterway adjacent to the Company's Tacoma, Washington metals processing facility. An estimate of this liability was initially recognized as part of the 1995 acquisition of the Tacoma facility. The cost estimate was based on the assumption that dredge removal of contaminated sediments would be accomplished within one dredge season during July 2004 through February 2005. However, due to a variety of factors, including dredge contractor operational issues and other dredge related delays, the dredging was not completed during the first dredge season. As a result, the Company increased its environmental reserve by \$7.7 million related to this project, primarily to account for additional estimated costs to complete this work during a second dredging season. The Company has filed a complaint to recover damages and a significant portion of the increased costs incurred in the second dredging season to complete the project.

**Interest Expense.** Interest expense for the second quarter of fiscal 2006 increased by \$0.1 million, or 16%, to \$0.4 million compared with the second quarter of fiscal 2005. The increase was a result of higher average debt balances and an increase in the loan interest rate during the fiscal 2006 second quarter compared with the fiscal 2005 second quarter. For more information, see Note 6 to the condensed consolidated financial statements.

**Income Tax Provision.** The 33% tax rate for the second quarter of fiscal 2006 is comparable to the 35% rate for the same quarter last year because the Company's management anticipates that the reduction of Extraterritorial Income Exclusion (ETI) tax benefits occasioned by the American Jobs Creation Act of 2004 (the Act) will be offset by the new Qualified Production Activities Income tax benefits brought about by the Act.

### First Half of Fiscal 2006 Compared to First Half of Fiscal 2005

**Revenues.** Consolidated revenues for the six months ended February 28, 2006 increased \$329.8 million, or 80%, from \$414.7 million in the first half of fiscal 2005. Revenues for the first half of fiscal 2006 increased for all of the Company's business segments. The Metals Recycling Business' revenues increased primarily as a result of the businesses acquired in the HNC separation and termination, and the acquisition of Regional. The Auto Parts Business revenues increased primarily as a result of the acquisition of GreenLeaf in September 2005 and four newly acquired self-service stores in January 2005. The Steel Manufacturing Business' revenues increased primarily as a result of strong West Coast demand, which led to higher sales volumes primarily for rebar.

SCHNITZER STEEL INDUSTRIES, INC.

The Metals Recycling Business generated revenues of \$536.4 million for the six months ended February 28, 2006, before intercompany eliminations, an increase of \$239.8 million, or 81%, over the same period of the prior year. This increase was caused by higher sales volume provided by the newly acquired businesses, which added revenue of approximately \$292.3 million, and was partially offset by an approximately \$52.5 million decline in revenues from the Company's previously owned West Coast recycled metals facilities due to lower average net selling prices.

Ferrous revenues for the Company's metals processing operations increased \$74.6 million, or 29%, to \$335.1 million. Total ferrous sales volume for the processing operations increased 514,000 tons, or 54%, over the prior year's first half to 1,461,000 tons, which was predominantly due to the newly acquired businesses in the Southeastern and Northeastern United States. Sales volume for the Company's previously owned West Coast operations decreased by 60,000 tons. The overall increase in volume was offset by a 16% decrease in the average net sales price to \$201 per ton for the Company's processed metals operations. Sales to the Steel Manufacturing Business increased 33,000 tons, or 12%, to 302,000 tons, while other domestic sales increased from 26,000 tons in the first half of fiscal 2005 to 217,000 tons in the same period of this year as a result of the Regional acquisition. The newly acquired metals trading operations of Schnitzer Global Exchange contributed \$112.0 million in revenues, based on sales of 461,000 tons, for the first half of fiscal 2006.

Revenue from Metals Recycling Business' nonferrous metal sales increased \$53.2 million, or 163%, over the first six months of fiscal 2005, which resulted from both a \$0.16, or 29%, increase in average net sales price to \$0.69 per pound and from an increase of 61.5 million pounds, or 102%, increase in pounds shipped. Total nonferrous shipped for the first half of 2006 was 121.8 million pounds. The increase in sales price per pound was primarily a result of the increased Asian demand for nonferrous metals and partially due to the Regional acquisition, as Regional's recycling operations produce a more valuable mix of the nonferrous product. The increase in pounds shipped was primarily due to the acquired businesses, which accounted for an additional 59.3 million pounds sold in the first half of fiscal 2006.

The Auto Parts Business generated revenues of \$95.9 million, before intercompany eliminations, for the six months ended February 28, 2006, an increase of \$48.0 million, or 100%, over the same period of the prior year. This increase in revenues was primarily due to the acquisition of GreenLeaf in September 2005 as well as the addition of four self-service stores in January 2005.

The Steel Manufacturing Business generated revenues of \$178.7 million for the six months ended February 28, 2006, an increase of \$41.8 million, or 31%, over the same period in the prior year. Sales volumes in the first half of 2006 increased 32% to 331,000 tons over the same period last year, increasing revenues by \$41.9 million, primarily due to stronger demand for rebar products. During the first half of fiscal 2005, customers reduced purchases of steel in an effort to reduce inventories on hand. By contrast, during the first half of fiscal 2006, customers were buying steel to replace inventories, and consumption of steel was strong. The average net selling price decreased by \$6 per ton, or 1%, to \$519 per ton, which resulted in decreased revenue of \$2.0 million.

**Cost of Goods Sold.** Consolidated cost of goods sold increased \$320.9 million, or 106%, for the six months ended February 28, 2006, compared with the same period last year. Cost of goods sold increased as a percentage of revenues from 73% to 84%.

For the six months ended February 28, 2006, the cost of goods sold for the Metals Recycling Business increased \$261.7 million, or 118%, to \$484.3 million compared to the first half of fiscal 2005. As a percentage of revenues, cost of goods sold increased compared with the prior year quarter from 75% to 90%. The increase in cost of goods sold was primarily attributable to the businesses acquired through the HNC separation and termination, as these businesses have been experiencing narrower margins than the Company's historical West Coast business. The margin variations for these businesses are due, in part, to more competitive markets for materials in the Northeast regions, higher operating expenses due to outdated and inefficient equipment, higher freight costs to access certain foreign markets

and the lower margins generally inherent in the Schnitzer Global

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Exchange trading business. The Company has begun a major capital improvement program to upgrade infrastructure and equipment in the Northeast and throughout the Company to become more efficient and improve productivity. In addition, the first quarter of fiscal 2006's East Coast processing volumes were negatively impacted by a two-month shutdown of the Rhode Island shredder to install a new, more efficient, and environmentally friendly shredder motor as well as low beginning inventories at all the Northeast yards. The lower processing volumes contributed to higher processing costs, which caused the East Coast operations to record a small loss for the quarter. While Schnitzer Global Exchange, the Company's new trading business, provides increased revenues, the associated trading margins are lower than the historical Metals Recycling Business. Although the Company attempts to maintain and grow margins by responding to changing recycled metals selling prices through adjustments to its metals purchase prices, the Company's ability to do so in the trading business is particularly limited by competitive and other market factors.

Cost of goods sold for the Auto Parts Business increased \$35.5 million, or 130%, compared to the first half of fiscal 2005. As a percentage of revenues, cost of goods sold increased compared with the prior year-to-date from 57% to 66%.

The higher cost of goods sold was primarily due to the acquisition of GreenLeaf in September 2005 and four self-service stores in January 2005. Cost of goods sold also increased due to strong demand for unprocessed metals that resulted in higher car purchase costs and because GreenLeaf typically purchases newer vehicles resulting in a higher purchase price and lower margins as compared to the older model vehicles that Pick-N-Pull purchases. During the first six months of fiscal 2005, the operations acquired in the GreenLeaf transaction recorded a slight operating loss as the Company continued the process of integrating GreenLeaf's operations into Pick-N-Pull's operations.

Cost of goods sold for the Steel Manufacturing Business increased \$27.4 million, or 23%, as compared to the first six months of fiscal 2005. The overall increase in cost of goods sold was primarily caused by a 32% increase in sales volume. As a percentage of revenues, cost of goods sold declined compared with the prior year-to-date, from 85% to 81%. The Steel Manufacturing Business continues to see the benefits from the new furnace installed at its mini-mill last year, production incentives recently negotiated with the steelworkers union and other improvements in business practices which has all contributed to reducing the cost of goods sold per ton. Overall, production and raw material purchase costs per ton have declined and sales volumes have improved, more than offsetting the decline in the average sales price.

***Selling, General and Administrative Expense.*** Compared with the first half of fiscal 2005, selling, general and administrative expense for the same period this fiscal year increased \$48.4 million, or 191%, to \$73.9 million. As a percentage of revenues, selling, general and administrative expense increased by 4%, from 6% to 10%. A significant portion of the increase, \$22.9 million, was attributed to the acquisitions that took place in the first quarter of fiscal 2006. Additionally, compensation costs increased approximately \$3.4 million as the Company's infrastructure has grown to accommodate these acquisitions. The increase in selling, general and administrative expense was also due, in part, to the charge associated with the reserve of \$11.0 million related to the penalties that the Company estimates will be imposed by the DOJ and the SEC in connection with the past payment practices in Asia, as discussed in Note 5 to the condensed consolidated financial statements. The Company also incurred higher legal, accounting and professional fees of \$3.5 million including a \$2.6 million increase in legal expenses related to the Audit Committee's investigation of past payment practices in Asia, as discussed in Note 5 to the condensed consolidated financial statements. The adoption of FAS 123(R) in fiscal 2006 resulted in stock-based compensation expense of \$1.6 million for the first half of fiscal 2006. The Company also recognized compensation costs of \$0.5 million for awards under its long-term incentive plan, approved in fiscal 2006 as discussed in Note 8 to the condensed consolidated financial statements.

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**Other Income (Expense).** The Company recorded a gain of \$54.6 million which arose from the HNC separation and termination. Based on the values determined by the valuations of the assets and liabilities acquired and assumed, the Company recorded a gain for the difference between the excess values of businesses acquired over the carrying value of the businesses sold. The Company elected to consolidate the results of two of the businesses formed from the HNC separation and termination as though the transactions had occurred at the beginning of the fiscal year. For a more detailed discussion of the HNC joint venture separation and termination, see Notes 2 and 4 to the condensed consolidated financial statements.

**Environmental Matter.** The Company did not incur any environmental matter charges during the first half of fiscal 2006. During the first half of fiscal 2005, the Company recorded environmental charges of \$8.2 million for additional estimated costs related to the ongoing remediation of the head of the Hylebos Waterway adjacent to the Company's Tacoma, Washington metals processing facility. An estimate of this liability was initially recognized as part of the 1995 acquisition of the Tacoma facility. The cost estimate was based on the assumption that dredge removal of contaminated sediments would be accomplished within one dredge season during July 2004 through February 2005. However, due to a variety of factors, including dredge contractor operational issues and other dredge related delays, the dredging was not completed during the first dredge season. As a result, the Company increased its environmental reserve by \$8.2 million related to this project, primarily to account for additional estimated costs to complete this work during a second dredging season. The Company has filed a complaint to recover damages and a significant portion of the increased costs incurred in the second dredging season to complete the project.

**Interest Expense.** Interest expense for the first half of fiscal 2006 increased by \$0.2 million, or 33%, to \$0.8 million compared with the first half of fiscal 2005. The increase was a result of higher average debt balances and an increase in the loan rate during the fiscal 2006 first half compared with the fiscal 2005 first half. For more information, see Note 6 to the condensed consolidated financial statements.

**Income Tax Provision.** The tax rate for the six months ended February 28, 2006 was 39.9%, compared to a 34.7% rate for the same period last year due to two events that occurred in the first quarter of fiscal 2006. First, an \$11.0 million charge was accrued for estimated penalties associated with the DOJ and SEC investigation, though the ultimate amount of penalties will not be determinable until the end of the investigation. This charge is currently being treated as nondeductible, pending an exact determination upon the eventual closure of the investigation. Secondly, the HNC separation and termination required the Company to record a gain of \$54.6 million for the difference between the fair market values of the businesses acquired over the carrying values of the businesses sold. Because the gain will not benefit from the Extraterritorial Income Exclusion (ETI) on export sales or the new Qualified Production Activities Income deduction, it will likely be taxed at an effective tax rate of 38%, which is higher than the rate applicable to the balance of the Company's income.

### **Liquidity and Capital Resources**

Certain items within the consolidated statements of cash flows have been restated. See Note 1 to the condensed consolidated financial statements for details of the restatement. Net cash provided by operations for the six months ended February 28, 2006 was \$60.2 million, compared with \$65.7 million for the same period in the prior fiscal year. Cash provided by operating activities was primarily related to a reduction in accounts receivable, inventories, prepaid expenses and other current assets, an increase in accrued liabilities and the distribution from the joint ventures associated with the HNC separation and termination agreement, which was offset by the gain on the disposition of the joint ventures, lower net income, and a reduction in accounts payable.

Capital expenditures for the six months ended February 28, 2006 were \$37.5 million, compared with \$15.2 million during the first six months of fiscal 2005. The increase was due to a significant number of on-going infrastructure improvement projects in the Company's Metals Recycling Business, including preparation for the installation of a mega-shredder and dock repairs in the Portland, Oregon recycling facility and the installation of a mega-shredder and

general yard improvements at the Everett, Massachusetts recycling facility. The Company

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also incurred expenditures in the Auto Parts Business for the conversion of full-service GreenLeaf locations into Pick-N-Pull self-service stores. The Company plans to invest an additional \$50.0 million on capital improvement projects in the next two fiscal quarters. Additionally, the Company continues to explore other capital projects that are expected to provide productivity improvements and add shareholder value.

Accrued environmental liabilities as of February 28, 2006 were \$45.1 million, compared with \$23.5 million as of August 31, 2005, due to the acquisitions discussed in Note 4 to the condensed consolidated financial statements, partially offset by spending charged against the environmental reserve. During the next 12 months, the Company expects to pay approximately \$6.6 million relating to previously accrued remediation projects, including the remediation on the Hylebos Waterway located in the State of Washington as discussed in Note 5 to the condensed consolidated financial statements. Additionally, the Company anticipates future cash outlays as it incurs the actual cost relating to the remediation of identified environmental liabilities. The future cash outlays are anticipated to be within the amounts established as environmental liabilities.

On November 8, 2005, the Company entered into an amended and restated unsecured committed bank credit agreement with Bank of America, N.A., as administrative agent, and the other lenders party thereto. The new agreement provides for a five-year, \$400.0 million revolving loan maturing in November 2010. The agreement prior to restatement provided for a \$150.0 million revolving loan maturing in May 2006. Interest on outstanding indebtedness under the restated agreement is based, at the Company's option, on either LIBOR plus a spread of between 0.625% and 1.25%, with the amount of the spread based on a pricing grid tied to the Company's leverage ratio, or the greater of the prime rate or the federal funds rate plus 0.50%. In addition, annual commitment fees are payable on the unused portion of the credit facility at rates between 0.15% and 0.25% based on a pricing grid tied to the Company's leverage ratio. The restated agreement contains various representations and warranties, events of default and financial and other covenants, including covenants requiring maintenance of a minimum fixed charge coverage ratio and a maximum leverage ratio. As of February 28, 2006, the Company had borrowings outstanding under this credit facility of \$70.0 million. As a result of the restatement, as discussed in Note 1 to the consolidated financial statements, the Company was not in compliance with their restrictive covenants. As such, a waiver was obtained from the lender, dated July 27, 2006, to waive any events of default provided the Company delivers its financial statements to the lender on or before September 8, 2006.

The Company also has an additional unsecured credit line, which was increased on March 1, 2006 by \$5.0 million to \$15.0 million. Interest on outstanding indebtedness is set by the bank at the time of borrowing. This additional debt agreement, which is uncommitted, also has certain restrictive covenants. As of February 28, 2006, the Company had no outstanding debt under this credit facility.

In July 2002, the Company's metals recycling joint ventures with HNC entered into a revolving credit facility (JV Credit Facility) with a group of banks for working capital and general corporate purposes. During February 2004, the facility was increased to \$110.0 million. Upon the closing of the agreement for the separation and termination of the Company's joint ventures with HNC on September 30, 2005, as described in Note 4 to the condensed consolidated financial statements, HNC paid the Company \$52.3 million in cash. The Company also received approximately \$1.4 million for previously undistributed earnings of the joint ventures net of the Company's share of outstanding borrowings under the JV Credit Facility as of that date. Following such earnings distributions, the Company and HNC each were obligated to repay the portion of the JV Credit Facility borrowed on behalf of the joint venture businesses it acquired in the transaction. The outstanding balance was repaid and the JV Credit Facility was terminated upon closing of the separation and termination agreement on September 30, 2005.

On September 30, 2005, the Company acquired GreenLeaf, five store properties leased by GreenLeaf and certain GreenLeaf debt obligations. Total consideration for the acquisition was \$44.5 million, subject to post-closing adjustments.



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On October 31, 2005, the Company acquired substantially all of the assets of Regional, a metal recycling business with ten facilities located in Georgia and Alabama. The purchase price was \$65.5 million in cash and the assumption of certain liabilities.

The increase in borrowings outstanding since August 31, 2005 was primarily the result of the acquisitions that occurred in the first quarter of fiscal 2006.

The Company makes contributions to a defined benefit pension plan, several defined contribution plans and several multiemployer pension plans. Contributions vary depending on the plan and are based upon plan provisions, actuarial valuations and negotiated labor agreements. The Company anticipates making contributions of approximately \$5.0 million to the various benefit plans in fiscal 2006, primarily in the third and fourth quarters.

Management evaluates long- and short-range forecasts as well as anticipated sources and uses of cash before determining the course of action that would best enhance shareholder value. During fiscal 2005 and the first half of fiscal 2006, the Company made significant investments in capital equipment and completed several acquisitions to both grow the business and enhance shareholder value. The Company is currently engaged in a growth strategy to enhance shareholder value. Pursuant to a stock repurchase program approved in 1996, the Company is authorized to repurchase up to 3.0 million shares of its stock when the market price of the Company's stock is not reflective of management's opinion of an appropriate valuation of the stock. During the first six months of fiscal 2006, the Company made no share repurchases. As of February 28, 2006, the Company had repurchased a total of 1.3 million shares under this program.

The Company believes its current cash resources, internally generated funds, existing credit facilities and access to the capital markets will provide adequate financing for capital expenditures, working capital, stock repurchases, debt service requirements, post retirement obligations and future environmental obligations for the next twelve months. In the longer term, the Company may seek to finance business expansion with additional borrowing arrangements or additional equity financing.

## **Outlook**

The Company believes the factors that will affect its results in the third quarter of 2006 include:

### **Metals Recycling Business:**

*Pricing.* The export markets are expected to remain subject to cyclical fluctuations. Based on sales booked to date and the Company's current view of the market, average net selling prices in the processing operation are expected to be up slightly from the second quarter of this year. Average sales prices in the Global Trading business are expected to approximate prices in the processing business as the product mix improves.

The Company continues to expect competition for the purchase of materials due to the strong world wide demand for recycled metal. However, purchase prices may rise at a lower rate than sales prices, providing an opportunity for improved margins.

*Sales volumes.* Ferrous scrap volumes in the domestic processing business are expected to increase slightly in the third quarter. Sales volumes in the Global Trading business are expected to nearly double from the second quarter as the impact of winter weather shipping conditions is reduced and higher market prices increase the flow of processed material available for purchase from Russia and the Baltic Sea region.



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**Auto Parts Business:**

The third quarter in the self-service Auto Parts Business has historically been one of the strongest periods for retail demand. Customer admissions and retail parts sales are expected to increase compared to the second quarter and be slightly improved from the third quarter of 2005. Wholesale revenues from the sale of cores and scrapped auto bodies are also expected to increase from the second quarter based on higher expected scrap metal prices.

Margins in the third quarter are expected to improve compared to the second quarter due to higher revenues from retail and core sales. As scrap prices remain high, the Company continues to see significant competition for the purchase of auto bodies, which results in higher costs to purchase inventory. Higher purchase costs for inventory are expected to result in margins which will be lower than during the third quarter of 2005.

The integration of the GreenLeaf operation is expected to result in the conversion of two additional full-service locations to self-service stores toward the end of the third quarter. Due to advertising and other start-up costs which are incurred before a store begins retail operations, the stores going through the conversion process will be a drag on operating earnings until such time as all stores are converted.

The GreenLeaf full-service operation is expected to break-even or post a small profit during the quarter.

**Steel Manufacturing Business:**

*Pricing.* West Coast consumption of finished steel long products continues to remain strong, and the Company is seeing good demand for rebar and merchant bar. Based on current market conditions, the Company expects average prices for the third quarter to approximate the second quarter of this year and be slightly higher than the third quarter of last year. Increased competition from imports, particularly for wire rod, could put downward pressure on pricing.

*Volumes.* The Company continues to see strong demand for finished steel products and customer inventories remain low. As a result, third quarter sales volumes are expected to be slightly higher than the 172,000 tons shipped in the third quarter of 2005.

*Factors That Could Affect Future Results*

This Form 10-Q, including Item 2 “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and including, particularly, the “Outlook” section, contains forward-looking statements, within the meaning of Section 21E of the Securities Exchange Act of 1934, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, without limitation, statements regarding the Company’s outlook for the business, and can be identified generally because they contain “expect,” “believe,” “anticipate,” “estimate” and other words that convey a similar meaning. One can also identify these statements as statements that do not relate strictly to historical or current facts. Examples of factors affecting the Company that could cause actual results to differ materially from current expectations are the following: volatile supply and demand conditions affecting prices and volumes in the markets for both the Company’s products and raw materials it purchases; world economic conditions; world political conditions; changes in federal and state income tax laws; impact of pending or new laws and regulations regarding imports and exports into the United States and other foreign countries; foreign currency fluctuations; competition; seasonality, including weather; energy supplies; freight rates; loss of key personnel; the inability to complete expected large scrap export shipments in the current quarter; consequences of the pending investigation by the

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Company's audit committee into past payment practices in Asia; business integration issues relating to acquisitions of businesses and the separation of the joint venture business described above; and business disruptions resulting from installation or replacement of major capital assets, as discussed in more detail under the heading "Factors That Could Affect Future Results" in the Company's most recent annual report on Form 10-K or quarterly report on Form 10-Q. One should understand that it is not possible to predict or identify all factors that could cause actual results to differ from the Company's forward-looking statements. Consequently, the reader should not consider any such list to be a complete statement of all potential risks or uncertainties. The Company does not assume any obligation to update any forward-looking statement.

Examples of factors affecting the Company that could cause actual results to differ materially are the following:

***Cyclical and General Market Considerations:*** Purchase and selling prices for recycled metals are highly cyclical in nature and subject to worldwide economic conditions. In addition, the cost and availability of recycled metals are subject to global supply and demand conditions which are volatile and beyond the Company's control, resulting in periodic fluctuations in recycled metals prices and working capital requirements. For example, beginning in fiscal 2004, and continuing into the first half of fiscal 2005, strong worldwide demand combined with a tight supply of recycled metals drove the Metals Recycling Business' average selling prices to unprecedented highs. However, average selling prices for recycled ferrous metals declined in the second half of fiscal 2005 due to the unsettled Asian markets, and continued to decline in the first half of fiscal 2006.

Fluctuations of prices for recycled ferrous metals have a significant impact on the results of operations for the Metals Recycling Business and to a lesser extent on the Auto Parts business. While the Company attempts to maintain and grow margins by responding to changing recycled metals selling prices through adjustments to its metals purchase prices, the Company's ability to do so is limited by competitive and other market factors. Increases in recycled metals selling prices may also adversely affect the operating results of the Company's Steel Manufacturing Business because increases in steel prices generally lag increases in ferrous recycled metals prices.

Additionally, changing prices could potentially impact the volume of recycled metal available to the Company, the subsequent volume of processed metal sold by the Company, inventory levels and the timing of collections and levels relating to the Company's accounts receivable balances.

The steel industry is also highly cyclical in nature and sensitive to general economic conditions. Presently, customer demand for steel products on the West Coast is good, and average prices for the Company's Steel Manufacturing Business are strong by historical standards. However, future economic downturns or a stagnant economy may adversely affect the performance of the Company's Steel Manufacturing Business.

The Company expects to continue to experience seasonal fluctuations in its revenues and net income. Revenues can fluctuate significantly quarter to quarter due to factors such as the seasonal slowdown in the construction industry, which is an important buyer of the Company's finished steel products. Weather and economic conditions in the United States and abroad can also cause fluctuations in revenue and net income.

Another factor which may affect revenues relates to the seasonal reduction in demand from foreign customers, who tend to reduce their finished steel production and corresponding scrap metal requirements during the summer months to offset higher energy costs.

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The Company makes a number of large ferrous recycled metals shipments to foreign steel producers each year. Customer requirements, shipping schedules and other factors limit the Company's control over the timing of these shipments. Variations in the number of foreign shipments from quarter to quarter will result in fluctuations in quarterly revenues and operating income. The Company's expectations regarding ferrous metal sales prices and volumes, as well as operating income, are based in part on a number of assumptions which are difficult to predict (for example, uncertainties relating to customer orders, metal availability, estimated freight rates, ship availability, cost and volume of unprocessed inventory and production output, etc.).

As a percentage of revenue, the Auto Parts Business' wholesale sales, including sales of auto bodies as well as cores, such as engines, transmissions, alternators and other nonferrous metals, have continued to grow in the past few years. Due to the nature of the wholesale business, which is more closely tied to the prices for recycled metals, the Auto Parts Business' results are increasingly subject to the volatility in the global recycled metals market more than they had been historically.

The Auto Parts Business experiences modest seasonal fluctuations in demand. The retail stores are open to the elements. During periods of extreme temperatures and precipitation, customers tend to delay their purchases and wait for milder conditions. As a result, retail sales are generally higher during the spring and fall of each calendar year and lower in the winter and summer months.

Additionally, the Auto Parts Business is subject to a number of other risks that could prevent it from maintaining or exceeding its current levels of profitability, such as volatile supply and demand conditions affecting prices and volumes in the markets for its products, services and raw materials; environmental issues; local and worldwide economic conditions; increasing competition; changes in automotive technology; the ultimate success of the Company's growth and acquisition plans; ability to build the infrastructure to support the Company's growth plans; and integration issues of the full-service business model.

**Backlog:** Historically, the Company has generally entered into export ferrous sales contract by selling forward 60 to 90 days. The backlog of sales contracts, coupled with knowledge of the price at which the processed material will be sold and the costs involved in processing the metals, allows the Company to take advantage of this differential in timing between purchases and sales and negotiate prices with suppliers that secure profitable sales transactions. As the difference in timing between the date the sales contracts are executed and the date of shipment grows shorter, it reduces the ability to manage the purchase price of raw material against the future sales price. The timing of forward contracts may impact the Company's revenue on a quarter-to-quarter basis as well as profitability on export shipments of ferrous metals.

**Competition:** The recycled metals industry is highly competitive, with the volume of purchases and sales subject to a number of competitive factors, principally price. The Company competes with both large and numerous smaller companies in its markets for the purchase of recyclable metals. The Company also competes with a number of domestic and foreign recycled metals processors and brokers for processed and unprocessed metal as well as for sales to domestic and foreign customers. For example, in 2001 and 2002, lower cost ferrous recycled metals supplies from certain foreign countries adversely affected market selling prices for ferrous recycled metals. Since then, many of these countries have imposed export restrictions which have significantly reduced their export volumes and lowered the worldwide supply of ferrous recycled metals. These restrictions are believed to have had a positive effect on the Company's selling prices. Given the intricacies in which the global markets operate, the Company cannot predict when or if foreign countries will change their trading policies and what effect, if any, such changes might have on the Company's operating results.

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From time to time, both the United States and foreign governments impose regulations and restrictions on trade in the markets in which the Company operates. In the second quarter of fiscal 2005, the Company received a certificate from China that allows the Company to continue shipping recycled metals into China. The certificate is part of a process designed to ensure safe industrial and agricultural production in China. Also, it is not unusual for various constituencies to petition government entities to impose new restrictions or change current laws. If imposed, these restrictions could affect the Company's margins as well as its ability to ship goods to foreign customers. Alternatively, restrictions could also affect the global availability of ferrous recycled metals, thereby affecting the Company's volumes and margins. As a result, it is difficult to predict what, if any, impact pending or future trade restrictions will have on the operations of the Company.

For the Metals Recycling Business, some of the more significant domestic competitors include regional steel mills and their brokers who compete for recycled metal for the purpose of providing the mills with feedstock to produce finished steel. During periods when market supplies of metal are in short supply, these buyers may, at times, react by raising buying prices to levels that are not reasonable in relation to more normal market conditions. As a result, the Company may have to raise its buying prices to maintain its production levels which may result in compressed margins.

The Auto Parts Business competes with both full-service and self-service auto dismantlers as well as larger well financed more traditional retail auto parts chains for retail customers. Periodically, the Auto Parts Business increases prices, which may affect customer flow and buying patterns. Additionally, in markets where the Company has one or only a few stores it does not have the same pricing power it experiences in markets where it has multiple locations. As this segment expands, the Company may experience new competition from others attempting to replicate the Company's business model. The ultimate impact of these dynamics cannot be predicted. The business competes for its automobile inventory with other dismantlers, used car dealers, auto auctions and metal recyclers. The Auto Parts Business has recently seen increased competition for automobile inventory from overseas mills and from motorists in Russia, Eastern Europe and Latin America. Inventory costs can fluctuate significantly depending on market conditions and prices for recycled metal.

The domestic steel industry also is highly competitive. Steel prices can be highly volatile and price is a significant competitive factor. The Company competes domestically with several steel producers in the Western United States for sales of its products. In recent years, the Company has experienced significant foreign competition, which is sometimes subsidized by large government agencies. There can be no assurance that such competition will not increase in the future. In the spring of 2002, the U.S. Government imposed anti-dumping and countervailing duties against wire rod products from eight foreign countries. However, there are other countries that import wire rod products where the imports are not subject to duties. These duties have assisted the Company in increasing sales of wire rod products; any expiration or termination of the duties could have a corresponding adverse effect. The Company has experienced increased competition for certain products by foreign importers during fiscal 2005 and 2006. In particular, in the West Coast market there has been an increase in the amount of imported wire rod which has lower selling prices than the Company's comparable products. The Company believes that the rise in import levels is attributable to the increase in selling prices in the West Coast market, which potentially allow the import sales to be more profitable to the foreign companies.

The steel manufacturing industry has been consolidating over the last several years and recently one of the Company's competitors closed its West Coast manufacturing facility. Any future start-up of operations of this manufacturing facility could negatively impact the Company's recycled metal and finished steel markets, prices, margins and potentially, cash flow.

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In general, given the unprecedented profitability levels of the Company and other recycled metals and steel companies over the last two years, competitors may be attracted to the Company's markets, which may adversely affect the Company's ability to protect its profit margins.

**Geographical Concentration:** Over the last few years, a significant portion of the revenues and operating profits earned by the Company's Metals Recycling Business has been generated from sales to Asian countries, principally China and South Korea. In addition, the Company's sales in these countries are also concentrated with relatively few customers that vary depending on buying cycles and general market conditions. The Company's sales have expanded to a broader geographic area with recent business acquisitions. As always, a significant change in buying patterns, political events, changes in regulatory requirements, tariffs and other export restrictions in the United States or these foreign countries, severe weather conditions or general changes in economic conditions could adversely affect the financial results of the Company.

**Pending Investigation:** As discussed in Part II, Item 1 "Legal Proceedings" and Note 5 to the condensed consolidated financial statements, the Board of Directors authorized the Audit Committee to engage independent counsel and conduct a thorough, independent investigation of the Company's past practice of making improper payments to the purchasing managers of customers in Asia in connection with export sales of recycled ferrous metals. The Board of Directors also authorized and directed that the existence and the results of the investigation be voluntarily reported to the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), and that the Company cooperate fully with those agencies. The Audit Committee notified the DOJ and the SEC of the independent investigation, engaged outside counsel to assist in the independent investigation and instructed outside counsel to fully cooperate with the DOJ and the SEC and to provide those agencies with the information obtained as a result of the independent investigation. On August 23, 2005, the Company received from the SEC a formal order of investigation related to the independent investigation. The Audit Committee is continuing its independent investigation. The Company, including the Audit Committee, continues to cooperate fully with the DOJ and the SEC. The investigations of the Audit Committee, the DOJ and the SEC of the Company's past practice of making improper payments are not expected to affect the Company's previously reported financial results. However, the Company expects to enter into agreements with the DOJ and the SEC to resolve the above-referenced matters and believes that it is probable that the DOJ and the SEC will impose penalties on, and require disgorgement of certain profits by, the Company as a result of their investigations. The Company estimates that the total amount of these penalties and disgorgement will be within a range of \$11.0 million to \$15.0 million. In the first fiscal quarter of 2006, the Company established a reserve totaling \$11.0 million in connection with this estimate. The precise terms of any agreements to be entered into with the DOJ and the SEC, however, remain under discussion with these two agencies. The Company, therefore, cannot predict with certainty the final outcome of the aforementioned investigations or whether the Company or any of its employees will be subject to any additional remedial actions following completion of these investigations. It is also possible that these investigations could lead to criminal charges, civil enforcement proceedings and civil lawsuits.

**Union Contracts:** The Company has a number of union contracts, several of which were recently re-negotiated. If the Company is unable to reach agreement on the terms of new contracts with any of its unions during future negotiations, the Company could be subject to work slowdowns or work stoppages.

**Post Retirement Benefits:** The Company has a number of post retirement benefit plans that include defined benefit, Supplemental Executive Retirement Benefit Plan (SERBP) and multiemployer plans. The Company's contributions to the defined benefit and SERBP plans are determined by actuarial calculations which are based on a number of estimates including the expected long-term rate of return on plan assets, allocation of plan assets between equity or fixed income investments, expected rate of compensation increases as well as other factors. Changes in these actual rates from year to year cause increases or decreases in the Company's annual contributions into the defined benefit plans and changes to the expenses recognized in a current fiscal year. Management and the actuary evaluate these rates annually and adjust if necessary.



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The Company's union employees participate in a number of multiemployer pension plans. The Company is not the sponsor or administrator of these multiemployer plans. Contributions are determined in accordance with provisions of the negotiated labor contracts.

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

Absent relief by the IRS, the plan's contributing employers will be required to make additional contributions or pay excise tax that may equal or exceed the full amount of the funding deficiency. The Company estimated its share of the required additional contribution for the 2004 plan year to be approximately \$1.1 million and accrued for such amount in fiscal 2004. Future funding deficiency assessments against the Company are possible until the multiemployer plan obtains a waiver from the IRS or the plan reaches the minimum funded status level required by the IRS.

***Recently Acquired Businesses and Future Business Acquisitions:*** As discussed above under "Acquisitions and Transactions" and in Note 4 to the condensed consolidated financial statements, the Company recently completed transactions to separate and terminate its metals recycling joint venture relationships with HNC and to purchase the assets of Regional and GreenLeaf. With the separation of the joint ventures, the Company acquired direct ownership of metals recycling businesses in the Northeast and Hawaii and a metals trading business in parts of Russia and the Baltic region. The day-to-day operations of these businesses were overseen by HNC prior to the separation. The Company will depend on key employees of those businesses, particularly those involved in the metals trading operations, to provide continuity in operating those businesses. The Company will also hire additional key employees to help manage those businesses. Loss of or failure to hire key personnel or other transition issues could adversely affect the Company.

Additionally, given the significance of these recently acquired businesses relative to the size of the Company, integration of these businesses will be challenging. Any failure to adequately integrate these businesses may result in adverse impacts on the Company's profitability.

The Company, throughout its history, has made a number of acquisitions as management attempts to improve the value of the Company for its shareholders. It is anticipated that the Company will continue to pursue additional expansion of the Metals Recycling Business and Auto Parts Business. Each acquisition comes with its own inherent risks that make it difficult to predict the ultimate success of the transaction. An acquisition may have a negative and/or unexpected impact on the Company's cash flow, operating income, net income, net income per share and financial position.

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**Trading Business Risks:** Schnitzer Global Exchange has various risks associated with its business operations. It operates in foreign countries with varying degrees of political risk. It advances and occasionally loans money to suppliers for the delivery of materials at a later date. Credit is also periodically extended to foreign steel mills. Due to the nature of the business, its profit margins are thinner than for the Company's processing business; thus, unsold inventory may be more susceptible to losses. In addition, inventory is generally purchased in advance of sale, and the Company has a lesser ability to manage the risk against adverse movements than in its domestic processing business. Also, the trading business has lower barriers to entry, making the Company potentially more susceptible to competition than in its processing business.

**Replacement or Installation of Capital Equipment:** The Company installs new equipment and constructs facilities or overhauls existing equipment and facilities (including export terminals) from time to time. Some of these projects take several months to complete, require the use of outside contractors and experts, require special permits and easements and have high degrees of risk. Examples of such major capital projects include the installation of a mega-shredder at a metal recycling yard, the overhaul of an export loading facility or the furnace replacement at the steel mill. Currently the Company is engaged in projects to install a mega-shredder and to repair the docks at the Portland, Oregon recycling facility and to install a mega-shredder and to make general yard improvements at the Everett, Massachusetts recycling facility. Many times in the process of preparing the site for installation, the Company is required to temporarily halt or limit production for a period of time. If problems are encountered during the installation and construction process the Company may lose the ability to process materials, which may impact the amount of revenue it is able to earn or may increase operating expenses. Additionally, it may also result in building inventory levels. If market conditions then occur which result in lower selling prices, the Company's profit margins may be adversely impacted. In either case, the Company's ability to reasonably predict financial results may be hampered.

**Reliance on Key Pieces of Equipment:** The Company relies on key pieces of equipment in the various manufacturing processes. These include the shredders and ship loading facilities at the metals recycling locations, the transformer, furnace, melt shop and rolling mills at the Company's steel manufacturing business, and the electrical power and natural gas supply into all of the Company's locations. If one of these key pieces of equipment were to have a mechanical failure and the Company were unable to correct the failure, revenues and operating income may be adversely impacted. Where practical, the Company has taken steps to reduce these risks, such as maintaining a supply of spare parts, performing a regular preventative maintenance program and maintaining a well-trained maintenance team that is capable of making most of the Company's repairs.

**Energy Supply:** The Company utilizes various energy sources to operate its facilities. In particular, electricity and natural gas currently represent approximately 9% of the cost of steel manufactured by the Company's Steel Manufacturing Business. The Steel Manufacturing Business purchases electric power under a long-term contract from McMinnville Water & Light (McMinnville), which in turn relies on the Bonneville Power Administration (BPA). Historically, these contracts have had favorable prices and are long-term in nature. The Company's electrical power contract expires in September 2011. On October 1, 2001, the BPA increased its electricity rates due to increased demand on the West Coast and lower supplies. This increase was in the form of a Cost Recovery Adjustment Clause (CRAC) added to BPA's contract with McMinnville. The CRAC is an additional monthly surcharge on selected power charges to recover costs associated with buying higher priced power during the West Coast power shortage. Because BPA can adjust the CRAC every six months, it is not possible to predict future rate changes.

The Steel Manufacturing Business also has a contract for natural gas that expires on May 31, 2009 and obligates the business to purchase minimum amounts of gas at fixed rates, which adjust periodically. Effective November 1, 2005, the natural gas rate increased to \$6.90 per MMBTU, and will increase to \$7.85 per MMBTU on April 1, 2006. This agreement is a take or pay contract with a minimum average usage of 3,575 MMBTU per day. Gas not used is sold on the open market and gains or losses are recorded in cost of goods sold.



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If the Company is unable to negotiate favorable terms of electricity, natural gas and other energy sources, this could adversely affect the performance of the Company.

**Environmental Matters:** The Company records accruals for estimated environmental remediation claims. A loss contingency is accrued when the Company's assessment indicates that it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. The Company's estimates are based upon currently available facts and presently enacted laws and regulations. These estimated liabilities are subject to revision in future periods based on actual costs, new information or changes in laws and regulations.

**Tax Laws:** The Company's tax rate the last three years has benefited from state income tax credits, from the federal Extraterritorial Income Exclusion (ETI) on export sales, and from the final releases of a valuation allowance previously offsetting the net operating losses and minimum tax credit carryforwards that had accompanied a 1996 business acquisition. The Company's future tax rates will continue to benefit from the ETI, although the American Jobs Creation Act of 2004 (the Act) will gradually eliminate the ETI benefit. Compensating for the Company's gradual loss of ETI benefit will be the new deduction under the Act for Qualified Production Activities Income, but the effect of this new deduction on the Company's effective tax rate will not be determinable until the newly issued final regulations explaining it are examined by the Company. The Company will also likely continue to benefit from trade tax credits.

**Currency Fluctuations:** Demand from the Company's foreign customers is partially driven by foreign currency fluctuations relative to the U.S. dollar. Strengthening of the U.S. dollar could adversely affect the competitiveness of the Company's products in the markets in which the Company competes. The Company has no control over such fluctuations and, as such, these dynamics could affect the Company's revenues and operating income. The Company conducts most transactions in U.S. dollars.

**Shipping and Handling:** Both the Metals Recycling Business and the Steel Manufacturing Business often rely on third parties to handle and transport their products to end users in a timely manner. The cost to transport the products can be affected by circumstances over which the Company has no control such as fuel prices, political events, governmental regulations on transportation and changes in market rates due to carrier availability. In estimating future operating results, the Company makes certain assumptions regarding shipping costs.

The Steel Manufacturing Business relies on the availability of rail cars to transport finished goods to customers and raw materials to the mill for use in the production process. Market demand for rail cars along the west coast has been very high, which has reduced the number of rail cars available to the Steel Manufacturing Business to transport finished goods. In addition, the Steel Manufacturing Business utilizes rail cars to provide an inexpensive form of transportation for delivering scrap metal to the mill for production. Although the Company expects to be able to maintain an adequate supply of scrap metal, a larger portion of those materials are anticipated to be delivered using trucks. The Company anticipates this change in delivery may lead to increased raw material costs.

The Metals Recycling Business relies on the availability of cargo ships to transport its ferrous and nonferrous bulk exports to Asian and other overseas markets. Demand for ocean going vessels has been strong, which has reduced the number of ships available to the Metals Recycling Business to transport product to markets. Although the Company anticipates that it will continue to find available vessels in a timely manner, the tight supply of ships could cause delays in meeting delivery schedules if vessels are not available.

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**Insurance:** The cost of the Company's insurance is affected not only by its own loss experience but also by cycles in the insurance market. The Company cannot predict future events and circumstances which could cause rates to materially change such as war, terrorist activities or natural disasters.

It is not possible to predict or identify all factors that could cause actual results to differ from the Company's forward-looking statements. Consequently, the reader should not consider any such list to be a complete statement of all potential risks or uncertainties. Further, the Company does not assume any obligation to update any forward-looking statement.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company periodically uses derivative financial instruments to limit exposure to changes in interest and foreign currency rates. Because such derivative instruments are used solely as hedges and not for speculative trading purposes, they do not represent incremental risk to the Company. For further discussion of derivative financial instruments, refer to “*Fair Value of Financial Instruments*” in the consolidated Financial Statements included in Item 8 of Form 10-K for the fiscal year ended August 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

**Disclosure Controls and Procedures**

The Company’s management, with the participation of the Chief Executive Officer and Chief Financial Officer, has completed an evaluation of the effectiveness of the design and operation of the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”). Based on this evaluation, the Company’s Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the fiscal period covered by the Original Form 10-Q, the Company’s disclosure controls and procedures were not effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission’s rules and forms and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

In making this determination the Company’s Chief Executive Officer and Chief Financial Officer considered, among other things, that:

The Company determined that it did not timely file with the SEC financial statements of the businesses it acquired through the termination and separation of its joint ventures with HNC on September 30, 2005, as required under Rule 3-05 and Article 11 of Regulation S-X. The Company filed the required financial statements with the SEC on July 10, 2006.

Further, the Company determined that the following material weaknesses existed as of February 28, 2006. A material weakness is a control deficiency or combination of control deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

1. As of February 28, 2006, the Company did not maintain effective controls over the accurate preparation and review of our consolidated statements of cash flows. Specifically, the Company did not maintain effective controls to ensure that (i) certain cash flows received from joint ventures as returns on investment were accurately classified as net cash provided by operations and (ii) debt proceeds and repayments and changes in other assets and liabilities were accurately presented on a gross basis, as required by generally accepted accounting principles. This control deficiency resulted in the restatement of the Company’s consolidated financial statements for the fiscal years ended August 31, 2005, 2004, and 2003, each of the quarters in fiscal 2005, the first two quarters of fiscal 2006 and adjustments to the third quarter of 2006. Additionally, this control deficiency could result in a misstatement of operating and investing cash flows in the consolidated statements of cash flows that would result in a material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, management has concluded that this control deficiency constitutes a material weakness.



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2. As of February 28, 2006, the Company did not maintain effective controls over its application and review of the completeness and accuracy of purchase accounting. Specifically, the Company did not maintain effective controls to ensure that purchase business combinations were accurately recorded as of the acquisition date in accordance with generally accepted accounting principles. This control deficiency resulted in the restatement of revenue, cost of goods sold, selling, general and administrative expense, interest expense, other income, net, income tax provision, pre-acquisition interests, net of tax, and operating and investing cash flows in the condensed consolidated financial statements for the three months ended November 30, 2005 and the six months ended February 28, 2006. Additionally, this control deficiency could result in the misstatement of the aforementioned accounts and disclosures that would result in a material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, management has concluded that this control deficiency constitutes a material weakness.

*Remediation Plan*

As of the date of the filing of this amendment on Form 10-Q/A, the Company has taken or will take the following steps to remediate the material weaknesses:

- The Company has created new accounting and financing positions, hired additional accounting and finance personnel in the third quarter of 2006 and replaced accounting and finance personnel hired earlier in fiscal year 2006.
- The Company has engaged outside consultants to review the Company's accounting position where the accounting treatment is considered by the Company to be particularly complex or, under certain circumstances, to involve subjective decision making.
- The Company reassembled its Technical Accounting Team, which includes the divisional CFO of the Auto Parts Business, the divisional Director of Finance of the Metals Recycling Business, the divisional Controllers of all the Company's business segments, the corporate Controller, the corporate Assistant Controller, the Finance Manager and the corporate Senior Accounting Manager. The Technical Accounting Team holds bi-monthly meetings to address accounting issues relevant to the Company.
- The Company has taken a thorough review of the classification requirements of each component line item and the individual elements that comprise each line item of the Consolidated Statements of Cash Flows in accordance with FAS 95.
- The SEC reporting manager will now utilize a detailed checklist to review appropriate classification of cash flows in accordance with FAS 95.
- The Company has contracted with a public accounting firm (other than its independent auditors) to perform a thorough review of the detailed checklist to ensure that the cash flows have been prepared in accordance with FAS 95.

**Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

SCHNITZER STEEL INDUSTRIES, INC.

PART II

ITEM 1.

LEGAL PROCEEDINGS

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

SCHNITZER STEEL INDUSTRIES, INC.

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

- (a) The 2006 annual meeting of the shareholders was held on January 30, 2006. Holders of 20,611,194 shares of the Company's Class A common stock, entitled to one vote per share, and 7,645,736 shares of the Company's Class B common stock, entitled to ten votes per share, were present in person or by proxy at the meeting.
- (b) Robert S. Ball, John D. Carter, Jill Schnitzer Edelson, William A. Furman, Judith A. Johansen, Scott Lewis, Kenneth M. Novack, Mark L. Palmquist, Jean S. Reynolds, and Ralph R. Shaw were elected directors of the Company.

(c) The meeting was called for the following purposes:

1. To elect Robert S. Ball, John D. Carter, Jill Schnitzer Edelson, William A. Furman, Judith A. Johansen, Scott Lewis, Kenneth M. Novack, Mark L. Palmquist, Jean S. Reynolds, and Ralph R. Shaw as directors of the Company.

This proposal was approved as follows:

|                        | Votes For  | Votes Withheld/Against |
|------------------------|------------|------------------------|
| Robert S. Ball         | 96,672,150 | 396,404                |
| John D. Carter         | 91,759,646 | 5,308,908              |
| Jill Schnitzer Edelson | 92,209,624 | 4,858,930              |
| William A. Furman      | 96,673,210 | 395,344                |
| Judith A. Johansen     | 96,807,789 | 260,765                |
| Scott Lewis            | 92,216,577 | 4,851,977              |
| Kenneth M. Novack      | 91,875,989 | 5,192,565              |
| Mark L. Palmquist      | 96,821,289 | 247,265                |
| Jean S. Reynolds       | 92,214,840 | 4,853,714              |
| Ralph R. Shaw          | 96,486,236 | 582,318                |

2. To approve the proposed amendments to the 1993 Stock Incentive Plan.

This proposal was approved by the stockholders with 89,477,802 votes cast for, 554,453 votes withheld/cast against and 20,684 abstentions.

SCHNITZER STEEL INDUSTRIES, INC.

ITEM 6. EXHIBITS

- 3.1 1993 Restated Articles of Incorporation of the Registrant (as amended as of March 24, 2006) (incorporated by reference to Exhibit 3.1 to Registrant's Current Report on Form 10-Q filed April 10, 2006).
- 3.2 Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 to Registrant's Current Report on Form 8-K filed on March 22, 2006).
- 4.1 Rights Agreement, dated as of March 21, 2006, between Schnitzer Steel Industries, Inc. and Wells Fargo Bank, N.A. which includes as Exhibit A the form of Articles of Amendment for Series A Participating Preferred Stock, as Exhibit B the form of Class A Right Certificate, as Exhibit C the form of Class B Right Certificate, and as Exhibit D the Summary of Rights to Purchase Series A Shares (incorporated by reference to Registrant's Current Report on Form 8-K filed on March 22, 2006).
- 10.1 Letter agreement, dated January 6, 2006, between Schnitzer Steel Industries, Inc. and Gregory J. Witherspoon, regarding Mr. Witherspoon's position as Chief Financial Officer (incorporated by reference to Registrant's Current Report on Form 8-K filed on January 10, 2006).
- 10.2 Letter agreement, dated January 6, 2006, between Schnitzer Steel Industries, Inc. and Richard C. Josephson, regarding Mr. Josephson's position as Vice President and General Counsel (incorporated by reference to Registrant's Current Report on Form 8-K filed on January 10, 2006).
- 10.3 1993 Stock Incentive Plan, as amended January 30, 2006 (incorporated by reference to Registrant's Current Report on Form 8-K filed on February 3, 2006).
- 10.4 Form of Long-Term Incentive Award Agreement under the 1993 Stock Incentive Plan (incorporated by reference to Registrant's Current Report on Form 8-K filed on February 3, 2006).
- 10.5 Employment Agreement with John D. Carter (incorporated by reference to Registrant's Current Report on Form 8-K filed on February 22, 2006).

- 10.6 Change in Control Severance Agreement with John D. Carter (incorporated by reference to Registrant's Current Report on Form 8-K filed on February 22, 2006).
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SCHNITZER STEEL INDUSTRIES, INC.

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.

SCHNITZER STEEL INDUSTRIES, INC.  
(Registrant)

Date: August 30, 2006

By: /s/ John D. Carter

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John D. Carter  
Chief Executive Officer

Date: August 30, 2006

By: /s/ Gregory J. Witherspoon

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Gregory J. Witherspoon  
Chief Financial Officer

