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Henry Bros. Electronics, Inc.  
Form 10KSB  
March 31, 2006

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-KSB  
 ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND  
EXCHANGE ACT OF 1934, AS AMENDED

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
AND EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

Commission File No. 005-62411

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HENRY BROS. ELECTRONICS, INC.

(Name of small business issuer as specified in its charter)

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Delaware 22-3690168  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

280 Midland Avenue, Saddle Brook, New Jersey 07663  
(address of principal executive offices) (Zip Code)

Issuer's Telephone number, including area code: (201) 794-6500

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Securities registered pursuant to Section 12(b) of the Act: None

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Securities registered pursuant to Section 12(g) of the Act:

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Common Stock, \$.01 par value  
(Title of Class)

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

Check if disclosure of delinquent filers pursuant to item 405 of Regulation S-B

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is not contained herein, and will not be contained, to the best of the Registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this form 10-KSB or any amendment to this Form 10-KSB. [ ]

State the aggregate market value of the voting stock held by non-affiliates of the Issuer: \$18,677,128 (based upon the closing price of Issuer's Common Stock, \$.01 par value, as of March 21, 2006).

The Registrant's revenues for the year ended December 31, 2005 were \$42,156,188.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date.

|   |   |
|---|---|
| Common Stock, \$.01 Par Value<br>(Title of Class) | 5,896,065<br>(No. of Shares Outstanding<br>at March 21, 2006) |
|---|---|

Documents Incorporated By Reference:  
None

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## Forward Looking Statements

This annual report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to differ materially from those stated. Such statements are subject to certain risks and uncertainties, including our ability to utilize the acquisitions we have made; possible significant variations in recognized revenue due to customer caused delays in installations; cancellation of contracts by our customers and competition, that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company does not assume any obligation to update the forward-looking information and cautions readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

## PART I

### Item 1. Description of Business

#### (a) Business Development.

In 1950, John, Ray, and Hartford Henry founded Henry Bros. Electronics. They sold Henry Bros. Electronics to Communication Group, Inc. ("CGI") in 1985. In 1989, Jim Henry, our Chairman and Chief Executive Officer, and Irvin Witcosky, our President and Chief Operating Officer reacquired certain assets, including the name Henry Bros. Electronics ("HBE") from CGI. In 1991 we acquired the assets of the former Motorola CCTV division and formed Viscom Products, Inc. ("Viscom"). In 1999 we formed a company named Integcom Corp. incorporated in Delaware into which we transferred both HBE and Viscom. In 2001 we changed our name to Diversified Security Solutions, Inc. and in 2005 we changed our name to Henry Bros. Electronics, Inc.

In November 2001, we completed our initial public offering, including the underwriter's over-allotment option of an aggregate of 1,725,000 shares of common stock. Our shares are traded on the American Stock Exchange under the ticker symbol HBE.

In May 2002, we purchased Photo Scan Systems, Inc. ("Photo Scan") a security integrator located in southern California and changed its name to Henry Bros. Electronics, Inc. in December 2002.

In August 2002, Photo Scan acquired National Safe of California, Inc. which sells and services alarm security equipment, lock and timing mechanisms, vault security, control and backup systems and high resolution security

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equipment used by commercial banks.

In September 2002, Photo Scan acquired Corporate Security Integration, LLC. ("CSI") a security integrator located in Phoenix, Arizona, and subsequently changed its name to Henry Bros. Electronics, LLC.

In April 2004, we acquired Airorlite Communications, Inc., a company located in Saddle Brook, New Jersey, that specializes in the design, manufacture and maintenance of wireless communications equipment used to enhance emergency radio frequency services and cellular communication for both fixed and mobile applications.

In October 2005, we acquired Securus, Inc. a security integrator with offices in Denver and Colorado Springs, Colorado.

Our principal executive offices are located at 280 Midland Avenue, Saddle Brook, New Jersey 07663, and our telephone number is (201) 794-6500.

### (b) Business of Issuer

We are a single-source/turn-key provider of technology-based security solutions for medium and large commercial enterprises and government agencies in the United States.

Security Distributing and Marketing magazine ("SDM") ranks by 2004 revenue the top 100 largest firms selling closed circuit TV ("CCTV"), access control and integrated security systems. We were ranked No. 21 in SDM's Top Systems Integrators Report published in July 2005.

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As a single-source/turn-key provider of diversified technology-based integrated security solutions, we can expedite project completion and optimize system manpower performance. The continually evolving security requirements of commercial and government entities, together with rapidly advancing technology, provides numerous opportunities for us to assist our clients with their security needs.

We believe that the following key attributes provide us with a sustainable competitive advantage:

- o Experience and expertise;
- o Technological sophistication;
- o Quality control; and
- o Strong list of references.

### Our Strategy

Our strategy consists of the following components:

- o Maintain and develop long-term relationships with clients;
- o Focus on high value-added services;
- o Continue to expand our client base in targeted industries;
- o Maintain a high level of technological sophistication;
- o Sell additional services to our established client base; and
- o Pursue strategic acquisitions that would be complementary to our business and accretive to earnings

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Our operations are divided into two business segments - Security System Integration ("Integration") and Specialty Products and Services ("Specialty"). The Integration segment provides a cradle to grave services for a wide variety of security, communications and control systems. The Company specializes in turnkey systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. In October 2005 the Company acquired Securus, Inc. a provider of security system integration with offices in Denver and Colorado Springs Colorado. The Specialty Products and Services segment ("Specialty") includes the Company's digital mobile recording business, Viscom Products, Inc. ("Viscom") and the Emergency Preparedness Planning Programs ("EPPP") division. In April 2004, the Company acquired Airorlite Communications, Inc. ("Airorlite") which is included within the Specialty segment. Airorlite specializes in designing, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. Each of the Company's segments markets nationwide with an emphasis in the New Jersey/New York, Southern California, Dallas, Phoenix and Denver metropolitan areas. Customers are primarily medium and large businesses and governmental agencies. The Company derives a majority of its revenues from project installations and to a smaller extent, maintenance service revenue.

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### Our Integration Solution

At the beginning of each new client relationship, we designate one member of our professional staff as the client service contact. This individual is the point person for communications between the client and us and often serves as the client's project manager for all of its security needs. Our engagement may include:

- o Consulting and planning;
- o Engineering and design;
- o Systems installation and management;
- o Systems training; and
- o Maintenance and technical support.

### Consulting and Planning

Security consulting and planning are the initial phases of determining a security solution for a project. We have developed a planning process that identifies all systems, policies and procedures that are required for the successful operation of a security system that will both meet a client's current needs and accommodate its projected future requirements. Our consulting and planning process includes the following steps:

- o Identify the client's objectives and security system requirements;
- o Survey the site(s), including inventory of physical components and software and evaluation of client's existing infrastructure and security system;
- o Assess and prioritize the client's vulnerabilities;
- o Develop and evaluate system alternatives;
- o Recommend a conceptual security plan design;
- o Estimate the cost of implementing the conceptual plan; and
- o Develop a preliminary implementation schedule.

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As a result of this process, we provide the client with a master plan for an effective security solution that addresses routine operating needs as well as emergency situations.

We believe that our comprehensive planning process enables our clients to budget for their security requirements on a long-term basis, identify opportunities for cost reduction and prepare for future risks.

### Engineering and Design

The engineering and design process involves preparation of detailed project specifications and working drawings by a team of our engineers, systems designers and computer-aided design system operators. These specifications and drawings detail the camera sensitivity requirements, layout of the control center, placement of cameras, card readers and other equipment and electrical requirements. Throughout our engineering and design process, our goal is to understand our client's operational preferences in order to design a system that is functional, cost-effective and accommodates our client's present and future requirements. In addition, we attempt to incorporate our client's existing personnel, equipment and other physical resources into the system design.

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When retained as a single-source provider for turnkey security solutions, we select system components required under the specifications and drawings. We recommend that our customers buy proven off-the-shelf devices and software and resort to custom equipment only when absolutely necessary.

We have made a strategic decision not to represent any equipment manufacturer exclusively, thereby maintaining objectivity and flexibility in equipment selection. We believe that our technical proficiency with the products available from a wide range of manufacturers enables us to select components that will best meet a project's requirements.

### Systems Installation and Management

Under the supervision of the manager of the project, our technicians install hardware, integrate hardware and software, and validate and test the system. Subcontractors typically perform the aspects of systems integration that do not require a high level of technical expertise, such as wire installation and basic construction. Components that may be integrated in a security system include the following:

- o Access control systems, which are designed to exclude unauthorized personnel from specified areas;
- o Intrusion detection systems, which detect unauthorized door and window openings, glass breakage, vibration, motion, noise and alarms and other peripheral equipment;
- o Closed circuit television systems, which monitor and record entry and exit activity or provide surveillance of designated areas;
- o Critical condition monitoring systems, which provide alarm monitoring and supervision of various systems and facilities; and
- o Intercoms, public address, fire detection signals and network connectivity that can expand a local security system into a closely controlled worldwide system.

### Systems Training

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Upon completion of a systems integration project, we typically will provide the customer with system documentation and training in the operation and maintenance of the system.

### Maintenance and Technical Support

We provide maintenance and technical support services on a scheduled, on-call, or emergency basis. These services include developing and implementing maintenance programs both for security systems designed, engineered, or integrated by us and for existing systems.

### Our Specialty Solutions

Viscom specialty is integrating digital video and voice recording solutions for mobile deployment on municipal buses and trains. Viscom solutions include products manufactured by third party vendors. Airorlite specializes in designing, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. Our EPPP division works with high-

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rise office building management to analyze their specific facilities needs relating to emergency response plans and the communication and training of such plans to the building community.

### Marketing

Our marketing activities are conducted on both national and regional levels. We obtain engagements through direct negotiation with clients, competitive bid processes and referrals. At the national level, we conduct analyses of various industries and target those with significant demand for security solutions. At a regional level, we have developed and implemented a marketing plan that targets specific regions of the country. The plan identifies prospective clients within specific regions of the country and sets forth a strategy for developing relationships with them.

We have developed expertise in the security regulations applicable to airports and seaports, high-rise buildings, public transportation systems, healthcare, financial, educational and other vertical markets. We have identified several key industries or facility types that we believe have substantial and increasing requirements for security services, including corporate campuses and federal facilities.

### Customers

We provide our products and services to customers in the public and private sectors through direct sales to end-users and through subcontracting agreements and have provided services to customers representing each of the vertical markets described under Marketing.

### Competition

The security industry is highly fragmented and competitive. We compete on a local, regional and national basis with systems integrators, consulting firms

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and engineering and design firms. Our competitors include equipment manufacturers and vendors that also provide security services. Many of our competitors have greater name recognition and financial resources. We believe that we compete primarily on our ability to deliver solutions that effectively meet a client's requirements and, to a lesser extent and primarily in competitive bid situations, on price. Many of the larger public sector projects require performance bonds, which may limit our ability to compete with larger competitors as the prime contractor, depending upon the specifications of the project.

### Employees

As of February 2006, we had 172 full time employees, including officers, of whom: 122 were engaged in engineering, systems installation and maintenance services, 22 in administration and accounting, and 28 in marketing and sales. None of our employees are covered by a collective bargaining agreement or are represented by a labor union. We consider our relationship with our employees to be satisfactory.

Our business requires substantial technical capabilities in many disciplines, from mechanics and computer science to electronics and advanced software. We emphasize continued training for new and existing technical personnel. Accordingly, we conduct training classes and seminars in-house, send select employees to technical schools and avail ourselves of training opportunities offered by equipment manufacturers and other specialists on a regular basis.

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### Pricing

We employ a variety of pricing strategies for our services. Systems integration projects are based upon the estimated cost of the equipment for the project including a profit margin, plus the estimated hours for each skill set, required to complete the project multiplied by the rate quoted, plus a profit margin. Pricing for engineering and maintenance services are determined based on the scope of the specific project and the length of our engagement. Proposals for consulting and threat assessment services are priced based on an estimate of hours multiplied by standard rates or on a project basis.

### Risk Factors

Our business, operations and financial conditions are subject to various risks. Some of these are described below. This section does not describe all risks that may be applied to our Company, our industry or our business and is intended only as a summary of certain material risk factors.

We are dependent upon a small number of customers for a large portion of our revenues

We have a small number of customers from which we receive a large portion of our revenues. Our work with the Triborough Bridge & Tunnel Authority accounted for 15% of total revenue during 2005, with our five largest customers represented approximately 37% of our 2005 revenue. Revenues from governmental agencies accounted for 39% in 2005 versus 20% in 2004. Consequently, we are often required to replace one customer with one or more other customers in order to generate the same amount of revenues. There can be no assurance that we will



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continue to be able to do so.

Some of our orders and contracts may be cancelled or modified so there is a risk that our backlog may not be fulfilled

Some of our orders and contract backlog are subject to cancellation or modification by our customers at any time so we cannot be certain that we will recognize revenues from them. As of December 31, 2005, our backlog was approximately \$16,003,000.

We are dependent on a few vendors and rely on timely delivery of equipment from outside sources

There are a few vendors from whom we obtain devices and software for specific access control, imaging, remote transmission, smart key and mobile applications. The loss of any one of these companies as suppliers could have a materially adverse impact on our business, financial condition and results of operations if we are unable to develop or acquire new technologies from other sources. We believe there are alternative vendors to source such products.

Timely vendor deliveries of equipment meeting our quality control standards from all suppliers are also important to our business because each installed system requires the integration of a variety of elements to be fully functional. The failure to deliver any component when required, in operating condition, can delay the project, triggering contract penalties, delay in progress payments and may result in cancellation of the project.

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We have not been consistently profitable and may not be profitable in the future

For the years ended December 31, 2005 and 2004 our revenues were \$42,156,188 and \$29,725,718, respectively, and our net income was \$1,108,278 and \$44,021 respectively. Our profit has not been continuous and we can make no assurances that we will be profitable in the future.

We experience intense competition for business from a variety of sources

In systems integration, we compete for new business with large construction firms, electrical contractors and consultants in the security business and other systems integrators. Many of our competitors are much larger and have greater resources. In order to effectively compete in the future, we may have to charge less for our services, which may result in lower profit margins.

We rely on only a few key executives

James E. Henry and Irvin F. Witcosky, our two key executives, are vital to our business operations. The loss of either of them could have a materially adverse impact on our business, financial condition or results of operations.

Our business and growth will suffer if we are unable to hire and retain highly skilled personnel

Competition for highly skilled employees is intense in our industry. The design and manufacture of our equipment, and the installation of our systems,

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requires substantial technical capabilities in many disparate disciplines from mechanics and computer science to electronics and advanced software. Our future success depends on our ability to attract, train, motivate and retain highly skilled employees. If we are unable to hire and retain skilled personnel, our growth may be restricted, the quality of our products and services diminished and our revenues and the value of your investment reduced. There is no assurance that we will be able to retain our skilled employees or attract, assimilate and retain other highly skilled employees in the future.

### Lengthy revenues cycle

Revenue of our services and products frequently involves a substantial commitment of resources to evaluate a potential project and prepare a proposal. In addition, approval of proposals often involves a lengthy process due to clients' internal procedures and capital expenditure approval processes. We may not be awarded a project that we have prepared a proposal for and, even if we are, a substantial period of time may elapse from when we make a proposal to when we can recognize revenues from the project.

### Seasonality

Revenues of our services have typically been seasonal in nature and there could be periods of fluctuations in revenue volume due to the timing of project installations or factors that are beyond the Company's control, such as weather and construction delays.

We may make acquisitions or form joint ventures that are unsuccessful

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Part of our growth strategy involves acquisitions or joint ventures with other system integrators. This strategy is subject to the following risks, the occurrence of which could have a materially adverse impact on our business, financial condition or results of operations:

- o We may not be able to identify suitable acquisition and joint venture candidates.
- o If the purchase price of an acquisition includes cash, we may need to use a significant portion of our available cash or credit facility with our bank.
- o We could have difficulty assimilating the acquired company's operations and personnel or working with the joint venture. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses and charges.
- o We may not be able to retain key employees of the acquired companies or maintain good relations with its customers or suppliers.
- o We may be required to incur additional debt.
- o We may be required to issue equity securities to pay for such acquisition, which will dilute existing shareholders.
- o We may have to incur significant accounting charges, such as for an impairment of intangible assets, which may adversely affect our results of operations.

The Chief Executive Officer and Chief Operating Officer own a significant amount of our common stock and their interests may be different from and

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conflict with yours

The interests of the Chief Executive Officer and Chief Operating Officer could conflict with the interests of our other stockholders. Mr. Henry and Mr. Witcosky beneficially own a total of approximately 47.5% of our outstanding common stock. Accordingly, if they act together, they may have the power to control the election of all of our directors or other issues for which the approval of our shareholders is required.

The trading volume in our common stock fluctuates and as a result you may find it difficult to sell your shares of our common stock.

Our common stock is listed on the American Stock Exchange. Trading in our common stock fluctuates and on some days is minimal. Failure to maintain an active trading market in our common stock could negatively affect the price of our common stock and your ability to sell our common stock.

### Item 2. Description of Property

We lease a 17,055 square foot sales, office, and integration facility that also serve as our corporate office in Saddle Brook, New Jersey. This facility is a portion of a single-story, cinder block building in a commercial and industrial park. The lease on this space terminates on June 30, 2006, and provides for an annual rent of \$98,400 until that date, payable in equal monthly installments of \$8,200, plus taxes of approximately \$600 per month. We are also responsible for the cost of property tax increases, utilities, repairs, maintenance, alterations, cleaning and insurance.

We lease a 9,553 square foot sales and office facility in Fullerton, California. A two-story, concrete building in an office complex, this space is leased until November 15, 2006 at an average

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annual rent of \$111,398 payable in equal monthly installments of \$9,283, with additional costs for insurance, repairs and alterations, utilities, taxes increases and cleaning.

We lease a 4,200 square foot sales and office facility in Grand Prairie, Texas near the Dallas-Fort Worth Airport. A single-story, cinder block building in an office complex, this space is leased until February 28, 2007 at an annual average rental of \$39,600, payable in equal monthly installments of \$3,300, with additional costs for insurance, repairs and alterations, utilities, taxes and cleaning.

We lease a 3,906 square foot sales and office facility in Phoenix, Arizona. A single-story, concrete building in an office complex, this space is leased until August 2006 at an average annual rental of \$60,576, payable in average monthly installments of \$5,048, with additional costs for insurance, repairs and alterations, utilities, taxes increases and cleaning.

We sublease approximately 1,750 square feet of office space in New York City for sales and project management personnel. This lease expires on October 31, 2006, with an annual rental of \$28,800, payable in equally monthly installments of \$2,400, inclusive of utilities.

Our Airorlite subsidiary leases a 5,440 square foot sales, office and

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warehouse facility in Saddle Brook, New Jersey. This facility is in a single-story, cinder block building in a commercial and industrial park. The lease on this space terminates on June 30, 2006, and provides for an annual rent of \$38,080 until that date, payable in equal monthly installments. We are also responsible for the cost of property tax increases, utilities, repairs, maintenance, alterations, cleaning and insurance.

Our Securus, Inc. ("Securus") subsidiary leases a 16,045 square foot sales, office and warehouse facility in Denver, Colorado. This facility is in a single-story, cinder block building in a commercial and industrial park. The lease on this space terminates April 2010 and provides for an annual rent of \$88,248 until that date, payable in equal monthly installments. Securus also leases 3,500 square feet of office and warehouse space in Colorado Springs, Colorado which terminates December 2010 and provides for an annual rent of \$23,832 payable in equal monthly installments. Securus is responsible for the cost of property taxes, utilities, repairs, maintenance, alterations, cleaning and insurance for both of these leased properties.

These facilities or similar facilities should meet our operational needs for the foreseeable future.

### Item 3. Legal Proceedings

We know of no material litigation or proceeding, pending or threatened, to which we are or may become a party.

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

No matters were submitted for a vote to our stockholders during our 2005 fourth quarter.

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## PART II

### Item 5. Market for Common Equity and Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities

Our Common Stock is traded on the American Stock Exchange under the Symbol "HBE".

(a) The following table indicates high and low stock prices for each period.

| 2004           | High   | Low    |
|----------------|--------|--------|
| ----           | -----  | -----  |
| First Quarter  | \$6.88 | \$5.50 |
| Second Quarter | \$9.90 | \$6.35 |
| Third Quarter  | \$9.00 | \$5.20 |
| Fourth Quarter | \$5.55 | \$4.81 |
| 2005           |        |        |
| ----           |        |        |
| First Quarter  | \$5.75 | \$4.45 |
| Second Quarter | \$5.05 | \$3.10 |
| Third Quarter  | \$6.85 | \$3.89 |
| Fourth Quarter | \$5.95 | \$4.20 |

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- (b) Number of Holders of Common Stock. The number of holders of record of our Common Stock on December 31, 2005 was 35. Since a portion of the shares of the common stock are held in street or nominee name, it is believed that there are significant number of additional number of beneficial owners of common stock.
- (c) Dividends. There were no cash dividends or other cash distributions made by us during the year ended December 31, 2005. Future dividend policy will be determined by our Board of Directors based on our earnings, financial condition, capital requirements and other existing conditions. It is anticipated that cash dividends will not be paid to the holders of our common stock in the foreseeable future.
- (d) In connection with the acquisition of Securus Inc. on October 10, 2005, the Company issued an aggregate of 150,001 shares of its common stock of which 150,001 are being held in escrow pursuant to the stock purchase escrow agreement between the Company and the selling shareholders of Securus, Inc. The issuance of the shares of restricted stock in connection with the aforementioned acquisition was made in reliance upon the exemption provided in section 4(2) of the Securities Act of 1933, as amended.

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- (e) Securities authorized for issuance under equity compensation plans.

| Plan category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted average exercise price of outstanding options, warrants and rights<br>(b) | Number remaining after future issuances of securities<br>c |
|--|--|--|--|
| Equity compensation plans approved by security holders     | 471,375 *  | \$5.95   |  |
| Equity compensation plans not approved by security holders | 239,662 **   | \$7.48   |  |
| Total  | 711,037  | \$6.47   |  |

\* This amount includes options issuable pursuant to our 2002 Stock Option Plan. Our Board of Directors approved this plan on May 10, 2002. Our shareholders' approved it on October 28, 2002. The plan authorizes the issuance of options to purchase up to 230,000 share of our Common Stock to employees, directors, and consultants of the Company.

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Also included are options issuable pursuant to our Incentive Stock Option Plan. The Board of Directors and our shareholders approved the adoption of the Incentive Stock Option Plan on December 23, 1999. Our Incentive Stock Option Plan provides for the granting of options to purchase a maximum of 500,000 shares of the Company's common stock.

\*\* This amount includes a five year options (currently exercisable) granted to the Wall Street Group ("WSG") consisting of (i) 40,000 shares granted November 5, 2001 with an exercise price of \$7.00 per share and (ii) 5,996 shares granted November 5, 2002 with an exercise price of \$6.90 per share,, issued in connection with an agreement to provided certain services dated November 1, 2001 and terminated in April 2003. Also included are warrants to purchase 138,333 and 55,333 shares at \$7.60 expiring January 27, 2010, that were granted in connection with the issuance of 553,333 shares of our common stock to certain qualified institutional investors and the placement agent, respectively, in July 2004

### Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

We are a single-source/turn-key provider of technology-based security solutions for medium and large commercial enterprises and government agencies in the United States.

As a single-source/turn-key provider of diversified technology-based integrated security solutions, we can expedite project completion and optimize system manpower performance. The continually evolving security requirements of commercial and government entities, together with rapidly advancing technology, provides numerous opportunities for us to assist our clients with their security needs.

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Our operations are divided into two business segments - Security System Integration ("Integration") and Specialty Products and Services ("Specialty"). The Integration segment provides cradle to grave services for a wide variety of security, communications and control systems. The Company specializes in turnkey systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. In October 2005 the Company acquired Securus, Inc. a provider of security system integration with offices in Denver and Colorado Springs Colorado. The Specialty Products and Services segment ("Specialty") includes the Company's digital mobile recording business, Viscom Products, Inc. ("Viscom") and the Emergency Preparedness Planning Programs ("EPPP") division. In April 2004, the Company acquired Airorlite Communications, Inc. ("Airorlite") which is included in the Specialty segment. Airorlite specializes in designing, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. Each of the Company's segments markets nationwide with an emphasis in the New Jersey/New York, Southern California, Dallas, Phoenix and Denver metropolitan areas. Customers are primarily medium and large businesses and governmental agencies. The Company derives a majority of its revenues from project installations and to a smaller extent, maintenance service revenue.

Comparison of the year ended December 31, 2005 to the year ended December 31, 2004

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### Revenues

Revenues for the year ended December 31, 2005 were \$42,156,188, representing an increase of \$12,430,470 or 41.8%, as compared to \$29,725,718 for the year ended December 31, 2004. The increase in revenue was principally related to an increase of \$12,593,273 in the Company's integration business. The New Jersey/New York region accounted for approximately \$11.5 million of the increased Integration revenue of which single customer project represented approximately \$5.2 million. Our backlog for this single customer project at December 31, 2005 was approximately \$3.2 million as compared to \$6.8 million at December 31, 2004. In October 2005, the Company acquired Securus, Inc., a provider of security integration systems. Revenues for Securus were \$1,101,509 for the period October 11, 2005 through December 31, 2005. Revenues to governmental agencies represented 39% and 20% of total revenues, for the years ended December 31, 2005 and 2004, respectively.

### Cost of Revenues

Cost of revenues for the year ended December 31, 2005 was \$31,581,187, as compared to \$22,305,632 for the year ended December 31, 2004. This was an increase of \$9,275,555 or 41.6% Gross profit margin was 25.1% for the year ended December 31, 2005, as compared to 25.0 % for the year ended December 31, 2004. Direct labor for our Integration segment decreased as a percent of revenue accounting for most of the increase in this segments gross profit margin to 24.3% for the year ended December 31, 2005 versus 22.3% for the prior year period. Our specialty segment gross profit margin decreased to 32.4% for the year ended December 31, 2005 versus 43.3% for the same period of the prior year. The decrease on a flat revenue comparison is due to a change in the revenue mix from Airorlite to Viscom.

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### Selling, General and Administrative Expenses

Selling, general and administrative expenses increased to \$8,467,192 for the year ended December 31, 2005, from \$7,020,885 for the year ended December 31, 2004. Selling, general and administrative expenses as a percentage of revenues decreased to 20.1% for the year ended December 31, 2005 versus 23.6% for the year ended December 31, 2004. This increase of \$1,446,307, or 20.6%, was primarily attributable to increased headcount and staff costs. As the Company's revenues increased in 2005, our corporate expenses decreased as a percent of our consolidated revenue to 3.3% for the year ended December 31, 2005 as compared with 4.4% for the same period of the prior year.

### Interest Income

Interest income for the year ended December 31, 2005 was \$12,507, as compared to \$12,624 for year ended December 31, 2004.

### Interest Expense

Interest expense for the year ended December 31, 2005 was \$84,985, as compared to \$94,039 for the year ended December 31, 2004. The decrease of \$9,054 was attributable to having an average lower debt balance of approximately \$1,279,468 for the year ended December 31, 2005 as compared to \$1,783,342 for the year ended December 31, 2004. This decrease was partially offset by increases in interest rates as the weighted average prime rate increased to 6.4%

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for the year ended December 31, 2005 versus 4.6% for the same period of the prior year.

### Net Income

As a result of the factors noted above, for the year ended December 31, 2005 our net income was \$1,108,278, as compared to a net income of \$44,021 for the year ended December 31, 2004. This resulted in basic earnings per share of \$0.19 on weighted average common shares outstanding of 5,739,398 for the year ended December 31, 2005, as compared to basic earnings per share of \$0.01 on weighted average common shares outstanding of 5,411,964 for the year ended December 31, 2004.

### Liquidity and Capital Resources

As of December 31, 2005, we had cash and cash equivalents of \$2,177,686, versus \$3,154,972 as of December 31, 2004. This decrease is primarily attributable to the acquisition of Securus, Inc in October 2005, in the net amount of \$1,110,000. We have a revolving loan facility of \$4,000,000 with Hudson United Bank that matures in May 2007. The amount available under the revolving credit facility was approximately \$4,000,000, as of December 31, 2005. Our working capital was \$10,302,321 as of December 31, 2005. We have total short-term debts due of approximately \$296,666 and purchase orders with our vendors to fulfill customer orders of approximately \$4,402,000.

During the year ended December 31, 2005, net cash provided by operations was \$999,808. We purchased property and equipment of \$202,240 and used \$690,326 in cash from financing

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activities. In addition, the company utilized \$1,110,000 of net cash to acquire Securus, Inc. in 2005.

Our capital requirements have grown substantially as a result of the growth of our operations and staffing since our public offering. Our cash and cash equivalents have decreased by \$977,286 during the year ended December 31, 2005, we believe that our current cash and available lines of credit should be sufficient to meet our capital requirements for the next twelve months. However, we may seek additional equity and /or debt financing to grow our operations.

### Critical Accounting Policies

The Company's consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates. Management uses its best judgment in valuing these estimates and may, as warranted, solicit external professional advice. The following critical accounting policies, some of which are impacted significantly by judgments, assumptions and estimates, affect the Company's consolidated financial statements.

### Revenue Recognition



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Revenue from a project integration in either the Integration or Specialty segments are recognized on the percentage of completion method, whereby revenue and the related gross profit are determined based upon the actual costs incurred to date for the project to the total estimated project costs to complete. Project costs generally include all material and shipping costs, the Company's direct labor, subcontractor costs and an allocation of indirect costs related to the direct labor. Changes in the project scope, site conditions, staff performance and delays or problems with the equipment used on the project can result in increased costs that may not be billable or accepted by the customer and results in a loss or lower profit from what was originally anticipated at the time of the proposal.

Estimates for the costs to complete the project is continuously updated by management during the performance of the project. Provision for changes in estimated costs and losses, if any, on uncompleted projects are made in the period in which such losses are determined. In general, we determine a project to be substantially completed after:

1. The scope of work is completed which includes installing the equipment as required in the contract.
2. System is functional and has been tested.
3. Training has been provided.

The majority of the Company's projects are completed within a year. Revenue from product sales are recognized when title and risk of loss passes to the customer.

Service contracts, which are generally separate and distinct agreements from project

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agreements, are billed either monthly or quarterly on the last day of the month covered by the contract. Accordingly, revenue from service contracts are recognized ratably over the length of the agreement. In 2004 and 2005, the company did not bundle any significant service contracts with our systems installation work.

The Emergency Preparedness Planning Programs division provides emergency planning services to commercial real estate owners and managers. In general, project labor is the predominant cost associated with the completion of these projects. The company utilizes labor as the output measure in order to recognize revenue and believes this to be an accurate matching of costs and revenue.

### Trade Receivables and Allowance for Doubtful Accounts

Trade receivables are stated at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts. The allowance is evaluated on a regular basis by management and is based upon historical experience with the customer, the aging of the past due amounts and the relationship with and economic status of our customers. The evaluation is based upon estimates taking into account the facts and circumstances at the time of the evaluation. Our trade receivables are not collateralized.

### Inventory Valuation

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Inventories are stated at the lower of cost or market value. Cost has been determined using the first-in, first-out method. Inventory quantities on-hand are regularly reviewed, and where necessary, reserves for excess and obsolete inventories are recorded

### Warranty

The Company offers warranties on all products, including parts and labor that range from one year to three years depending upon the type of product concerned. For products made by others, the Company passes along the manufacturer's warranty to the end user.

### Intangible Assets

The Company's intangible assets include goodwill and other intangibles that consist of the fair value of acquired customer lists, service contracts acquired, trade names, and covenants not to compete. Goodwill represents the excess of purchase price over fair value of net assets acquired.

Effective January 1, 2002, the company adopted the provisions of Statement of Financial and Accounting Standards (SFAS) 142 "Goodwill and Other Intangible Assets". In accordance with that statement goodwill and intangible assets with indefinite lives are not amortized, but are tested at least annually for impairment. Prior to January 1, 2002, the company had not recorded goodwill or other intangible assets of indefinite lives. Intangible assets with estimable useful lives, consisting primarily of acquired customer lists, service contracts and covenants not to compete are amortized on a straight-line basis over their estimated useful lives of three to fifteen years and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. If the intangible

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asset's remaining useful life is changed, the intangible asset will be amortized over the remaining useful life. If the asset being amortized is determined to have an indefinite useful life, the asset will be tested for impairment. The impairment test will consist of measuring its fair value with its carrying amount. If the carrying amount of the intangible assets exceeds its fair value, an impairment loss is recognized for an amount equal to the excess and the adjusted carrying amount is recognized as its new accounting basis

### Goodwill

The Company's goodwill impairment test is based on a two part procedure consistent with the requirements of SFAS 142. The first test consists of determining the fair value of the reporting unit and comparing it to the carrying value of the reporting unit. If the carrying value of the reporting unit exceeds the fair value of the reporting unit, a second test is performed. In step two, the implied fair value of the goodwill (which is the excess of the fair value of the reporting unit over the fair value of the net assets) is compared to the carrying value of the goodwill. An impairment loss is recognized for any excess value of goodwill over the implied value. We determined the Company's reporting unit by analyzing geographic region as management evaluates the Company's performance in this manner. We identified five separate and distinct operating units for the testing requirements of SFAS 142. We evaluate each reporting unit for impairment.

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### Income Taxes

Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

### Item 7. Financial Statements

Refer to pages F-1 through F-25.

### Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

During the year ended December 31, 2005, there were no changes in or disagreements with the Company's principal independent accountant on accounting or financial disclosure.

### Item 8A. Controls and Procedures

(a) The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer, Chief Operating Officer and Chief Financial Officer, of the design and operation of the Company's disclosure controls and procedures, as defined under Rule 13a-15(e) of the Securities and Exchange Act of

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1934, as of the end of the period covered by this report. Based upon that evaluation, the Company's Chief Executive Officer, Chief Operating Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures:

- (i) are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings;
- (ii) are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities and Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms; and
- (iii) include, without limitations, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities and Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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### (b) Change in Internal Controls over Financial Reporting

As required by Rule 13a-15(d), the Company's executive management including the Chief Executive Officer, the Chief Operating officer and the Chief Financial Officer, also conducted an evaluation of the Company's internal controls over financial reporting to determine whether any change occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting. Based on that evaluation, there have been no changes in the Company's internal controls over financial reporting during the year covered by this report that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

### Item 8B. Other Information

There were no events requiring disclosure that had not been made under Form 8K in the fourth quarter of our fiscal year.

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## PART III

### Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act and Code of Ethics

As of March 15, 2006, the Company's directors and executive officers were as follows:

| Name                | Age | Position  |
|---------------------|-----|---|
| ----                | --- | -----   |
| James E. Henry      | 52  | Chairman, Chief Executive Officer, Treasurer and Director |
| Brian Reach         | 51  | Vice Chairman, Secretary and Director                     |
| Irvin F. Witcosky   | 67  | President, Chief Operating Officer and Director           |
| Philip A. Timpanaro | 58  | Chief Financial Officer                                   |
| Robert DeLia Sr.    | 58  | Director  |
| James W. Power      | 76  | Director  |
| Joseph P. Ritorto   | 74  | Director  |
| David Sands         | 49  | Director  |

James E. Henry, our Chief Executive Officer, co-founded our predecessor company in 1989 and served as our President until December 2001 when he was elected our Chief Executive Officer and Chairman of the Board. Mr. Henry graduated from the University of New Hampshire with a Bachelor of Science degree in electrical engineering. In addition to his other responsibilities, Mr. Henry has continued to design, install, integrate and market security and communications systems as well as manage our research and development.

Brian Reach became a member of our board of directors in February 2004, serving as the Chairman of our Audit Committee until June 2004, when Mr. Reach became our Vice Chairman. In November 2004 Mr. Reach was appointed our Secretary. Mr. Reach began his career in 1976 with PricewaterhouseCoopers, becoming a CPA in 1980. From 1999 through 2002 Mr. Reach served as the Chief Financial Officer for Globix Corporation. Mr. Reach has also served as the Chief

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Financial Officer of IPC Communications, Inc., Celadon Group, Inc. and Cantel Medical Corp. Mr. Reach has a wide range of corporate finance, restructuring and governance experience having led the financing efforts to raise over \$1 billion during his career. He has also played key leadership roles in mergers and acquisitions, a leveraged recapitalization, debt restructurings and the development of controls for internal and external financial reporting. Mr. Reach graduated with a Bachelor of Science degree in Accounting from the University of Scranton.

Irvin F. Witcosky co-founded our predecessor company in 1989 and served as our Executive Vice President until December 2001 when he was elected our Chief Operating Officer and President. Mr. Witcosky has also served as our Secretary from 1989 to November 2004 and is on our Board of Directors. Mr. Witcosky graduated from California Polytechnic University with a Bachelor of Science degree in aeronautical engineering. In addition to his other responsibilities, Mr. Witcosky has continued to design, integrate and market security and communication systems as well as manage our operations and administration.

Philip Timpanaro joined our Company in February 2005 and became our Chief Financial

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Officer effective on April 1, 2005. Mr. Timpanaro has more than 30 years of executive-level experience in accounting and finance from a variety of companies in the engineering, construction and consulting industries. From 2000 to 2005 Mr. Timpanaro served as Corporate Controller for Varsity Plumbing & Heating, Inc, a \$15 million private company based in Flushing, New York. Prior to that, he served as Corporate Controller of ReGen Biologics, Inc. a public company whose stock is traded on the over-the-counter market. Mr. Timpanaro is a graduate of Bloomfield College with BS in Accounting.

Robert L. De Lia, Sr. has been a member of our Board since May 2004. From 2002 to 2003, Mr. DeLia was the chief executive officer of Airorlite Communications, Inc., a company that specialized in design, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. In April 2004 a wholly-owned subsidiary of the Company purchased all of the issued and outstanding shares of stock of Airorlite Communications, Inc. From 1987 to 1999, Mr. De Lia was the president and chief executive officer of Fiber Options, Inc. Mr. De Lia graduated from the New York Institute of Technology in 1969.

James W. Powers became a member of our Board in December 2005. Mr. Power brings more than 30 years of security industry experience to the Company. Mr. Power is the principal partner in J.W. Power & Associates and is a Director and Chairman of MDI, Inc. (a NASDAQ Company). He previously served as Chairman of the Board of InfoGraphic Systems Corp.; president and CEO of Martec\SAIC; President and CEO of Pinkerton Control Systems and has held senior executive positions with Cardkey Systems, Inc., Nitrol Corporation and TRW Data Systems. Previously, he has served as a Director of National Semiconductor, ICS Corporation, and Citicorp Custom Credit and Citicorp Credit Services.

Joseph P. Ritorto became a member of our Board in January 2002. Mr. Ritorto is the co-founder of First Aviation Services, Inc., which is located on Teterboro Airport in New Jersey and provides a variety of aviation support services. Mr. Ritorto has been an officer of First Aviation Services since 1986.

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From 1991, until he retired in May 2001, Mr. Ritorto served as Senior Executive Vice President and Chief Operating Officer of Silverstein Properties, Inc. and was responsible for leasing operations and directing the lease administration of Silverstein owned and managed properties.

David Sands is a certified public accountant and is a partner of Buchbinder Tunick & Company LLP where he is the head of the tax department. Mr. Sands is a member of the American Institute of Certified Public Accountants and the New York State Society of CPAs Mr. Sands has also lectured at the New York University Summer Continuing Education and the Foundation for Accounting Education Programs. Mr. Sands received a B.S. from SUNY at Buffalo and a M.S. in Taxation from Pace University.

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### Background Information About Certain Key Employees

Theodor Gjini has worked for us since 1988 in various capacities, including as a sales engineer and project manager. In his current position as a Vice President, he supervises the coordination of our personnel and their activities in project installations, engineering and maintenance. Mr. Gjini graduated from the New Jersey Institute of Technology with a Bachelor of Science degree in electrical engineering and William Paterson College with a master in business administration.

Emil J. Marone has worked for us since 1965 in various capacities, including as a hospital communication system specialist, security systems supervisor, systems engineer, and quality control specialist. In his current position as our Chief Technology Officer, he is responsible for the development of special products and testing procedures as well as quality assurance and management. He holds an associate science degree from Bergen County Community College.

Alex Pavlis has been a Vice President since April 2002. From January 2000 until March 2001, Mr. Pavlis was a Vice President of Sales and Marketing at Intellisec a systems integrator. In this capacity, Mr. Pavlis was responsible for all integrated security system sales in Northern and Southern California and in Arizona. From October 1983 to January 2000, Mr. Pavlis was a Vice President of Revenue and Marketing for UAC Security Systems where he oversaw UAC's integrated security system revenue and operations department.

Lee Masoian has been President of Airorlite Communications Inc. since its acquisition in April 2004. Mr. Masoian was a founder of Airorlite Communication Inc. and served as its President since incorporation in 2002. Mr. Masoian has held numerous technical positions in the wireless field for the past thirty years. He is a practicing engineer and led the development and design of many of the products that are offered by Airorlite. Mr. Masoian is a patent holder of several products. During his career, Mr. Masoian has held several positions of instructor and assistant professor at a number of junior and four year colleges. Mr. Masoian holds a BSEE and an MSEE from the Polytechnic Institute of NY with majors in communication theory.

### Audit Committee and Audit Committee Financial Expert

The Board has a separately designated, Audit Committee, in accordance with regulations of the Securities and Exchange Commission and the American Stock Exchange. The Audit Committee reviews, with the Company's independent public

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accountants, the scope and adequacy of the audit to be performed by the accountants, the Company's accounting practices, procedures and policies, and all related-party transactions. The Audit Committee has adopted an Audit Committee Charter. The Audit Committee met three times during 2005 and acted by written consent once. The Audit Committee currently consists of David Sands, James Power and Joseph Ritorto. The Board of Directors has determined that it has at least one expert serving on the Company's Audit Committee. The Company's Board of Director believes that David Sands is an "audit committee financial expert" and is an independent member of the Board of Directors.

### Compliance with Section 16(a) of the Exchange Act

The Securities and Exchange Act of 1934 requires our directors, officers and persons who own more than 10% of our Common Stock to file with the Securities and Exchange Commission

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initial reports and changes in beneficial ownership of our Common Stock and other equity securities. Our directors, officers and greater than 10% beneficial owners are required by SEC regulation to furnish us with copies of all Section 16(a) forms they file. To our knowledge, for the year ended December 31, 2005, based solely on a review of the copies of such reports furnished to the Company and representations by these individuals that no other reports were required during the year ended December 31, 2005, all Section 16(a) filing requirements applicable to our directors, officers and greater than 10% beneficial owners have been timely filed except that Messrs. Ritorto and DeLia did not timely file a Form 4. These forms have since been filed.

### Code of Ethics

The Company has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. A copy of our code of ethics is available on our website at [www.dssi-hq.com](http://www.dssi-hq.com) under the "Corporate Governance" section of the "Investors" web page.

### Item 10. Executive Compensation

The table below reflects information concerning the annual compensation for services in all capacities to the corporation for the fiscal years ended December 31, 2005, 2004 and 2003 of those persons who were, as of December 31, 2005, (a) the Chief Executive Officer, and (b) the four most highly compensated executive officers to the extent that such persons, total annual salary and bonus exceeded \$100,000.

#### SUMMARY COMPENSATION TABLE

| Name and Principal Position | Annual Compensation              | Long-Term<br>Compensation<br>Awards | Securities<br>Underlying | Options/SARS # |
|-----------------------------|----------------------------------|-------------------------------------|--------------------------|----------------|
|                             | Year(s) Salary (\$)(1) Bonus(\$) | -----                               | -----                    | -----          |
|                             |                                  |                                     |                          |                |

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|                                       |      |         |    |        |
|---------------------------------------|------|---------|----|--------|
| James E. Henry                        | 2005 | 130,680 | -- | --     |
| Chairman and Chief Executive Officer, | 2004 | 130,680 | -- | --     |
| Treasurer and Director                | 2003 | 163,350 | -- | --     |
| Irvin F. Witcosky                     | 2005 | 130,680 | -- | --     |
| President, Chief Operating Officer,   | 2004 | 130,680 | -- | --     |
| and Director                          | 2003 | 163,350 | -- | --     |
| Philip A. Timpanaro                   | 2005 | 104,231 | -- | 25,000 |
| Chief Financial Officer               |      |         |    |        |

(1) Effective in December 2003, Messrs Henry and Witcosky voluntarily reduced their salaries by twenty percent.

(2) Company matching contribution under its 401-K and profit sharing plan.

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(3) Mr. West resigned as our Chief Financial Officer in April 2005 and was replaced by Philip Timpanaro that same month.

The following table sets forth certain information with respect to stock options grants made to the named Executive Officers during 2005.

Option Grants in 2005  
Individual Grants

| Name                | Number of Securities Underlying Options Granted # | % of Total Options Granted to Employees in Fiscal Year | Exercised price per Share | Expiration Date |
|---------------------|---|--|---------------------------|-----------------|
| Philip A. Timpanaro | 25,000  | 12.2%  | \$5.65                    | 05/27/10        |

The following table sets forth information regarding options held by the named Executive Officers at December 31, 2005.

Aggregated Exercises and Year End Option Values in 2005

| Name                | Shares Acquired on Exercise | Values Realized | Number of Securities Underlying Unexercised Options at Year End # | Value of Unexercised In-the-Money Options at Year End \$ |
|---------------------|-----------------------------|-----------------|---|--|
| Brian Reach         | --                          | --              | 80,000/20,000   | --   |
| Philip A. Timpanaro | --                          | --              | 0/25,000  | --   |



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### Compensation of Directors

Directors who are also our employees receive no additional compensation for attendance at board meetings. The Company's non-employee directors receive a quarterly fee of \$1,250 and annual stock option grant to purchase 2,000 shares of the Company's common stock at the closing share price on the day of the grant and \$1,000 for attendance at each Board or Committee meeting. In August 2005, Messrs. DeLia Sr., Ritorto and Sands each received an option to purchase 2,000 shares of our common stock at \$4.90 exercisable through December 2010. All directors are entitled to be reimbursed for their travel, lodging and other out-of-pocket expenses related to their attendance at board and committee meetings.

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### Employment Agreements and Termination of Employment and Change in Control Arrangements

Messrs. Henry and Witcosky are serving as Chairman and Chief Executive Officer and President and Chief Operating Officer, respectively, under employment agreements for five years that commenced January 1, 2000. These agreements provide for an initial annual compensation of \$135,000, an increase of 10% in compensation as of January 2002 and in each subsequent year of the agreements and a one-year non-competition covenant covering the security business that commences after termination of employment. In December 2003, Messrs. Henry and Witcosky voluntarily waived the receipt of their respective salaries by twenty percent to help reduce the Company's costs. Through 2005 this salary reduction has not been restored.

### Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The table that follows sets forth, as of March 21, 2006 certain information regarding beneficial ownership of our common stock by each person who is known by us to beneficially own more than 5% of our common stock. The table also identifies the stock ownership of each of our directors, each of our officers, and all directors and officers as a group. Except as otherwise indicated, the stockholders listed in the table have sole voting and investment powers with respect to the shares indicated.

Unless otherwise indicated, the address for each of the named individuals is Henry Bros. Electronics, Inc., 280 Midland Avenue, Saddle Brook, New Jersey 07663.

Shares of common stock which an individual or group has a right to acquire within 60 days pursuant to the exercise or conversion of options, warrants or other similar convertible or derivative securities are deemed to be outstanding for the purpose of computing the percentage ownership of such individual or group, but are not deemed to be outstanding for the purpose of computing the percentage ownership of any other person shown in the table.

The applicable percentage of ownership is based on 5,896,065 shares outstanding as of March 21, 2006.

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| Name, Address and Title<br>of Beneficial Owner                                     | Number of<br>Shares<br>Beneficially<br>Owned | Percentage of<br>Common Stock<br>Beneficially<br>Owned |
|--|--|--|
| James E. Henry, Chairman, Chief Executive Officer,<br>Treasurer and Director ..... | 1,400,000                                    | 23.7%  |
| Irvin F. Witcosky, Chief Operating Officer, President,<br>and Director .....       | 1,400,000                                    | 23.7%  |
| Brian Reach, Vice Chairman, Secretary and Director (1)                             | 138,000                                      | 2.3%   |
| Philip A. Timpanaro, Chief Financial Officer (2) .....                             | 8,333  | *  |

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|  |           |       |
|--|-----------|-------|
| Robert DeLia Sr., Director (3) .....                                     | 41,000    | *     |
| James W. Power, Director (4) .....                                       | 2,000     | *     |
| Joseph Ritorto, Director (5) .....                                       | 44,000    | *     |
| David Sands, Director (6) .....  | 2,000     | *     |
| All executive officers and directors as a group<br>(8 persons) (7) ..... | 3,035,333 | 50.5% |

\* Less than 1%

(1) The amount shown for Mr. Reach includes a currently exercisable option to purchase 88,000 shares of the Company's Common Stock at a price of \$7.10 per share.

(2) The amount shown for Mr. Timpanaro includes a currently exercisable option to purchase 8,333 shares of the Company's Common Stock at a price of \$5.65 per share.

(3) The amount shown for Mr. DeLia Sr. includes two currently exercisable options to purchase 2,000 shares each of the Company's Common Stock at a price of \$7.19 and \$4.90 per share, respectively.

(4) The amount shown for Mr. Power includes a currently exercisable option to purchase 2,000 shares of the Company's Common Stock at a price of \$6.08 per share.

(5) The amount shown for Mr. Ritorto includes currently exercisable options to purchase 5,000 shares at \$7.95 and 2,000 shares each of the Company's common stock at \$7.19 and \$4.90 per share, respectively.

(6) The amount shown for Mr. Sands includes a currently exercisable option to purchase 2,000 shares of the Company's Common Stock at a price of \$4.90 per

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share.

(7) The amount shown includes currently exercisable options to purchase 113,333 shares of the Company's common stock.

### Item 12. Certain Relationships and Related Transactions

A corporation that Robert Benou, a former Company director, is an officer was paid consulting fees of \$3,000 for services provided during the year ended December 31, 2004.

### Item 13. Exhibits and Reports

See index of exhibits annexed hereto.

### Item 14. Principal Accountant Fees and Services

#### Audit Fees

The aggregate fees billed by Demetrius & Company, L.L.C. for professional services rendered for the audits of the Company's annual financial statements on Form 10-KSB and the reviews of the financial statements on Form 10-QSB for the fiscal year ended December 31, 2005 were \$94,179 and for the year ended December 31, 2004 were approximately \$60,400.

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#### Audit Related Fees

The aggregate fees billed for audit related services by the principal accountant for the year ended December 31, 2005 were approximately \$72,804 and for the year ended December 31, 2004 were \$14,900. Audit related services include due diligence in connection with acquisitions, consultation on accounting and internal control matters, audits in connection with proposed or consummated acquisitions and review of registration statements.

#### Tax Fees

The aggregate fees billed for tax compliance, tax advice and tax planning rendered by our independent auditors for the fiscal year ended December 31, 2005 was \$21,000, and for the year ended December 31, 2004 was \$20,000. The services comprising these fees include tax consulting and submitting tax returns.

#### All Other Fees

The aggregate fees billed for all other professional services rendered by the Company's independent auditors for the year ended December 31, 2005 was \$375 and for the year ended December 31, 2004 was \$800.

The Audit Committee approved 100% of the fees paid to the principal accountant for audit-related, tax and other fees. The Audit Committee pre-approves all non-audit services to be performed by the auditor. The percentage of hours expended on the principal accountant's engagement to audit the Company's financial statements for the most recent year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees was 0%.

SIGNATURES

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

Date: March 30, 2006

DIVERSIFIED SECURITY SOLUTIONS, INC.

By: /s/ James E. Henry

-----

James E. Henry  
Chairman, Chief Executive Officer, Treasurer  
and Director

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

SIGNATURE

Date: March 30, 2006

/s/ James E. Henry

-----

James E. Henry  
Chairman, Chief Executive Officer, Treasurer  
and Director

Date: March 30, 2006

/s/ Irvin F. Witcosky

-----

Irvin F. Witcosky  
Chief Operating Officer, President and Director

Date: March 30, 2006

/s/ Philip A. Timpanaro

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Philip A. Timpanaro  
Chief Financial Officer

Date: March 30, 2006

/s/ Robert DeLia Sr.

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Robert DeLia Sr.  
Director

Date: March 30, 2006

/s/ James W. Power

-----

James W. Power  
Director

Date: March 30, 2006

/s/ Joseph P. Ritorto

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Joseph P. Ritorto  
Director

Date: March 30, 2006

/s/ Brian Reach

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Brian Reach  
Vice Chairman, Secretary and Director

Date: March 30, 2006 /s/ David Sands  
-----  
David Sands  
Director

HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2005

|  |               |
|--|---------------|
| Report of Independent Registered Public Accounting Firm Report .....   | F - 1         |
| Consolidated Balance Sheet as of December 31, 2005 .....   | F - 2         |
| Consolidated Statements of Operations<br>for the Years Ended December 31, 2005 and 2004 .....                      | F - 3         |
| Consolidated Statements of Changes in Stockholders' Equity<br>for the Years Ended December 31, 2005 and 2004 ..... | F - 4         |
| Consolidated Statements of Cash Flows<br>for the Years Ended December 31, 2005 and 2004 .....                      | F - 5         |
| Notes to Consolidated Financial Statements .....   | F - 6 - F -24 |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and  
Stockholders of Henry Bros. Electronics, Inc.

We have audited the accompanying consolidated balance sheet of Henry Bros. Electronics, Inc. and Subsidiaries as of December 31, 2005, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the years in the two year period then ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Henry Bros. Electronics, Inc. and Subsidiaries as of December 31, 2005, and the consolidated results of their operations and their cash flows for each of the years in the two-year period then ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

s/s DEMETRIUS & COMPANY, L.L.C.

Wayne, New Jersey  
March 29, 2006

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2005

| ASSETS  |               |
|---|---------------|
| CURRENT ASSETS  |               |
| Cash and cash equivalents   | \$ 2,177,686  |
| Accounts receivable-net of allowance for doubtful accounts- \$811,389   | 9,934,954     |
| Inventory   | 1,227,871     |
| Costs in excess of billings and estimated profits                       | 3,110,798     |
| Deferred tax asset  | 931,529       |
| Prepaid expenses and income tax receivable                              | 250,187       |
| Other assets  | 327,535       |
| Total current assets  | 17,960,560    |
| PROPERTY AND EQUIPMENT - net of accumulated depreciation of \$2,621,115 | 1,123,561     |
| GOODWILL  | 2,904,344     |
| INTANGIBLE ASSETS - net of accumulated amortization of \$459,533        | 1,328,509     |
| DEFERRED TAX ASSET  | 55,000        |
| OTHER ASSETS  | 1,278,662     |
| TOTAL ASSETS  | \$ 24,650,636 |
| LIABILITIES & STOCKHOLDERS' EQUITY                                      |               |
| CURRENT LIABILITIES   |               |
| Accounts payable  | \$ 3,538,492  |
| Accrued expenses  | 1,598,086     |

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|   |               |
|---|---------------|
| Accrued taxes   | 461,494       |
| Billings in excess of costs and estimated profits   | 1,176,813     |
| Deferred income   | 570,489       |
| Current portion of long term debt   | 296,666       |
| Deferred tax liability  | 16,199        |
| Total current liabilities   | 7,658,239     |
| LONG-TERM DEBT, LESS CURRENT PORTION  | 727,961       |
| DEFERRED TAX LIABILITY  | 226,028       |
| TOTAL LIABILITIES   | 8,612,228     |
| STOCKHOLDERS' EQUITY  |               |
| Preferred stock, \$.01 par value; 10,000,000 shares authorized; no shares issued  | --            |
| Common stock, \$.01 par value; 10,000,000 shares authorized;<br>5,889,399 shares issued and outstanding in 2005 and 5,739,398 in 2004 | 58,894        |
| Additional paid in capital  | 16,956,008    |
| Deferred compensation   | (342,978)     |
| Accumulated deficit   | (633,516)     |
| TOTAL EQUITY  | 16,038,408    |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY  | \$ 24,650,636 |

The accompanying notes are an integral part of these statements

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

|   | For the Year ended<br>December 31, |               |
|---|------------------------------------|---------------|
|   | 2005                               | 2004          |
| Revenue                                   | \$ 42,156,188                      | \$ 29,725,718 |
| Cost of revenue                           | 31,581,187                         | 22,305,632    |
| Gross profit                              | 10,575,001                         | 7,420,086     |
| Operating Expenses:                       |                                    |               |
| Selling general & administrative expenses | 8,467,192                          | 7,020,885     |
| Operating profit                          | 2,107,809                          | 399,201       |
| Interest income                           | 12,507                             | 12,624        |
| Other Expense                             | (3,780)                            |               |
| Interest expense                          | (84,985)                           | (94,039)      |
| Income before tax expense                 | 2,031,551                          | 317,786       |

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|  |              |           |
|--|--------------|-----------|
| Tax expense                            | 923,273      | 273,765   |
|  | -----        | -----     |
| Net income after taxes                 | \$ 1,108,278 | \$ 44,021 |
|  | =====        | =====     |
| BASIC EARNINGS PER COMMON SHARE:       |              |           |
| Basic Profit Per Common Share          | \$ 0.19      | \$ 0.01   |
|  | =====        | =====     |
| Weighted Average Common Shares         | 5,739,398    | 5,411,964 |
|  | =====        | =====     |
| DILUTED EARNINGS PER COMMON SHARE:     |              |           |
| Diluted Profit Per Common Share:       | \$ 0.19      | \$ 0.01   |
|  | =====        | =====     |
| Weighted Average Diluted Common Shares | 5,773,097    | 5,411,964 |
|  | =====        | =====     |

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

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HENRY BROS. ELECTRONCS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

|  | Common Stock<br>par value \$.01 |                      | Treasury Stock | Additional         | De            |
|--|---------------------------------|----------------------|----------------|--------------------|---------------|
|  | 10,000,000<br>Shares            | Authorized<br>Amount | Shares         | Paid-in<br>Capital | en            |
|  | -----                           | -----                | -----          | -----              | -----         |
| Balance at December 31, 2003   | 5,201,431                       | \$ 52,015            | 70,891         | \$ (500,000)       | \$ 13,512,939 |
| Shares issued in connection with<br>the acquisition of Airorlite<br>Communications, Inc. | 37,000                          | 370                  |                |                    | 266,030       |
| Shares issued in July 2004 net<br>of expenses  | 553,333                         | 5,533                |                |                    | 2,952,524     |
| Employee stock options exercised   | 18,525                          | 185                  |                |                    | 123,108       |
| Value of stock option grants   |                                 |                      |                |                    | 247,056       |
| Amortization of value assigned to<br>stock option grants                                 |                                 |                      |                |                    |               |
| Treasury shares cancelled  | (70,891)                        | (709)                | (70,891)       | 500,000            | (499,291)     |
| Net Income for 2004  |                                 |                      |                |                    |               |
| Balance at December 31, 2004   | 5,739,398                       | 57,394               | --             | --                 | 16,602,366    |
| Value of stock option grants   |                                 |                      |                |                    | 355,142       |



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|   |           |           |    |    |               |         |
|---|-----------|-----------|----|----|---------------|---------|
| Amortization of value assigned to stock option grants             |           |           |    |    |               |         |
| Shares issued in connection with the acquisition of Securus, Inc. | 150,001   | 1,500     |    |    |               | (1,500) |
| Net Income for 2005   |           |           |    |    |               |         |
| Balance at December 31, 2005                                      | 5,889,399 | \$ 58,894 | -- | -- | \$ 16,956,008 | \$ (    |

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

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | For the years ended<br>December 31, |             |
|--|-------------------------------------|-------------|
|  | 2005                                | 2004        |
|  | -----                               | -----       |
| Cash flows from operating activities:  |                                     |             |
| Net income   | \$ 1,108,278                        | \$ 44,021   |
| Adjustments to reconcile net income (loss) from operations to net cash provided by (used in) operating activities: |                                     |             |
| Depreciation and amortization  | 637,941                             | 490,856     |
| Bad debt expense   | 453,889                             | 203,324     |
| Impairment Charges   | 44,999                              | 77,000      |
| Stock option expense   | 191,106                             | 68,114      |
| Deferred income taxes  | 788,471                             | 471,228     |
| Changes in operating assets and liabilities:   |                                     |             |
| Accounts receivable  | (1,327,191)                         | (2,525,791) |
| Inventories  | (353,296)                           | 214,664     |
| Costs in excess of billings and estimated profits  | (525,876)                           | (1,819,017) |
| Other assets   | (1,019,060)                         | 69,168      |
| Prepaid Expenses and income tax receivable   | 220,210                             | (284,770)   |
| Accounts payable   | 201,181                             | 1,121,607   |
| Accrued expenses   | 225,646                             | 839,245     |
| Billings in excess of cost and estimated profits   | (174,485)                           | 873,783     |
| Deferred Income  | 527,995                             | (112,783)   |
| Net cash provided by (used in) operating activities  | 999,808                             | (269,351)   |
| Cash flows from investing activities:  |                                     |             |
| Purchase of business, net of cash acquired   | (1,084,528)                         | (166,875)   |
| Purchase of property and equipment   | (202,240)                           | (236,295)   |
| Net Cash used in investing activities  | (1,286,768)                         | (403,170)   |
| Cash flows from financing activities:  |                                     |             |

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|  |              |              |
|--|--------------|--------------|
| Proceeds from issuance of common stock - net of fees | --           | 3,081,350    |
| Net (payments) proceeds from revolving bank lines    | 951,692      | (600,000)    |
| Payments of bank loans                               | (1,545,171)  | (305,215)    |
| Net (payments) and proceeds of other debt            | (18,498)     | (149,699)    |
| Capitalized lease payments                           | (78,349)     | (26,359)     |
| Payment of loan payable to owner of acquired company | --           | (100,000)    |
|  | -----        | -----        |
| Net Cash provided by (used in) financing activities  | (690,326)    | 1,900,077    |
|  | -----        | -----        |
| Increase (decrease) in cash and cash equivalents     | (977,286)    | 1,227,556    |
| Cash and cash equivalents - beginning of period      | 3,154,972    | 1,927,416    |
|  | -----        | -----        |
| Cash and cash equivalents - end of period            | \$ 2,177,686 | \$ 3,154,972 |
|  | =====        | =====        |
| Supplemental disclosure of cash flow information:    |              |              |
| Amount paid for the period for:                      |              |              |
| Interest   | \$ 84,985    | \$ 94,039    |
| Taxes  | \$ 41,124    | \$ 9,334     |
| Non-cash investing and financing activities:         |              |              |
| Equipment financed                                   | \$ 151,154   | \$ 258,841   |
| Issuance of stock to acquire businesses              | --           | \$ 266,400   |
| Value of stock options issued to employees           | \$ 355,142   | \$ 247,056   |

The accompanying notes are an integral part of the financial statements.

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements

NATURE OF OPERATIONS

Henry Bros. Electronics, Inc., (the "Company") and its subsidiaries, are divided into two business segments - Security System Integration ("Integration") and Specialty Products and Services. The Integration segment provides design, installation and support services for a wide variety of security, communications and control systems. The Company specializes in turnkey systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. In October 2005 the Company acquired Securus, Inc. a provider of security system integration with offices in Denver and Colorado Springs Colorado. The Specialty Products and Services segment ("Specialty") includes the Company's digital mobile recording business, Viscom Products, Inc. and its emergency preparedness planning programs business. In April 2004, the Company acquired Airorlite Communications, Inc. ("Airorlite") which is included within the Specialty segment. Airorlite specializes in designing, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. Each of the Company's segments markets nationwide with an emphasis in the New Jersey/New York, Southern California, Dallas, Phoenix and Denver metropolitan areas. Customers are primarily medium and large businesses and governmental agencies. The Company derives a majority of its revenues from project installations and to a smaller extent, maintenance service revenue. The table below shows revenue percentage by geographic location for the years ended December 31:

2005                      2004

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|                      |       |       |
|----------------------|-------|-------|
|                      | ----  | ----  |
| New Jersey/ New York | 53%   | 35%   |
| California           | 23    | 33    |
| Texas                | 8     | 13    |
| Arizona              | 6     | 7     |
| Colorado             | 2     | -     |
|                      | ----  | ----  |
| Integration segment  | 92    | 88    |
| Specialty segment    | 9     | 13    |
| Inter-segment        | (1)   | (1)   |
|                      | ----  | ----  |
| Total revenue        | 100%  | 100%  |
|                      | ===== | ===== |

The Company's headquarters are located in Saddle Brook, New Jersey with sales and service facilities located near the Dallas-Fort Worth Airport, Phoenix Arizona Airport, Denver and Colorado Springs, Colorado, two facilities in Saddle Brook, New Jersey, Fullerton, California and New York City.

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation - The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions have been eliminated in consolidation.

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#### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

Revenue Recognition - Revenue from a project integration in either the Integration or Specialty segments are recognized on the percentage of completion method, whereby revenue and the related gross profit are determined based upon the actual costs incurred to date for the project to the total estimated project costs to complete. Project costs generally include all material and shipping costs, the Company's direct labor, subcontractor costs and an allocation of indirect costs related to the direct labor. Changes in the project scope, site conditions, staff performance and delays or problems with the equipment used on the project can result in increased costs that may not be billable or accepted by the customer and results in a loss or lower profit from what was originally anticipated at the time of the proposal.

Estimates for the costs to complete the project are continuously updated by management during the performance of the project. Provision for changes in estimated costs and losses, if any, on uncompleted projects are made in the period in which such losses are determined. In general, we determine a project to be substantially completed after:

1. The scope of work is completed which includes installing the equipment as required in the contract.
2. System is functional and has been tested.
3. Training has been provided.

The majority of the Company's projects are completed within a year. Revenue from product sales are recognized when title and risk of loss passes to

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the customer.

Service contracts, which are generally separate and distinct agreements from project agreements, are billed either monthly or quarterly on the last day of the month covered by the contract. Accordingly, revenue from service contracts are recognized ratably over the length of the agreement. In 2004 and 2005, the company did not bundle any significant service contracts with our systems installation work.

The Emergency Preparedness Planning Programs division provides emergency planning services to commercial real estate owners and managers. In general, project labor is the predominant cost associated with the completion of these projects. The company utilizes labor as the output measure in order to recognize revenue and believes this to be an accurate matching of costs and revenue.

Use of Estimates - The preparation of financial statements, in conformity with generally accepted accounting principles in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities, at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

Revenue and costs relating to security integration systems projects and service agreements are particularly affected by management's estimates. The contract sale price and estimated costs are based upon the facts and circumstances known at the time of the proposal. Estimates for the costs to complete the contract is continuously updated during the performance of the contract. Unpredictable events can occur during the performance of the contract that can increase the costs and reduced the estimated gross profit. Change orders to record additional costs may not be approved or can become subject to long negotiations with the customer and can result in concessions by the Company. Considerable judgments are made during the performance of the contract that affects the Company's revenue recognition and cost accruals that may have a significant impact on the results of operations reported by the Company.

Cash Equivalents - The Company considers highly liquid instruments with original maturity of three months or less to be cash equivalents.

Trade Receivables - Trade receivables are stated at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts. The allowance is evaluated on a regular basis by management and is based upon historical experience with the customer, the aging of the past due amounts and the relationship with and economic status of our customers. The evaluation is based upon estimates taking into account the facts and circumstances at the time of the evaluation. Our trade receivables are not collateralized.

Inventories - Inventories are stated at the lower of cost or market value. Cost has been determined using the first-in, first-out method. Inventory quantities on-hand are regularly reviewed, and where necessary, reserves for excess and obsolete inventories are recorded.

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Property and Equipment - Property and equipment are recorded at cost, net of accumulated depreciation. Depreciation is computed on a straight-line basis over estimated useful lives of five to seven years. Leasehold improvements are amortized over the shorter of related lease term or the estimated useful lives. Upon retirement or sale, the costs of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of income. Repairs and maintenance costs are expensed as incurred. Annually, the Company routinely reviews its property and equipment for impairment, and accordingly, will write-down those assets to their estimated fair value.

Intangible Assets - The Company's intangible assets include goodwill and other intangibles that consist of the fair value of acquired customer lists, service contracts acquired, trade names, and covenants not to compete. Goodwill represents the excess of purchase price over fair value of net assets acquired.

Effective January 1, 2002, the company adopted the provisions of Statement of Financial and Accounting Standards (SFAS) 142 "Goodwill and Other Intangible Assets". In accordance with that statement goodwill and intangible assets with indefinite lives are not amortized, but are tested at least annually for impairment. Prior to January 1, 2002, the company had not recorded goodwill or

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

other intangible assets of indefinite lives. Intangible assets with estimable useful lives, consisting primarily of acquired customer lists, service contracts and covenants not to compete are amortized on a straight-line basis over their estimated useful lives of three to fifteen years and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. If the intangible asset's remaining useful life is changed, the intangible asset will be amortized over the remaining useful life. If the asset being amortized is determined to have an indefinite useful life, the asset will be tested for impairment. The impairment test will consist of measuring its fair value with its carrying amount. If the carrying amount of the intangible assets exceeds its fair value, an impairment loss is recognized for an amount equal to the excess and the adjusted carrying amount is recognized as its new accounting basis. The company recorded an impairment charge of approximately \$45,000 and \$77,000 for the write down of customer lists and service contract rights for the years ended December 31, 2005 and December 31, 2004, respectively.

Goodwill - The Company's goodwill impairment test is based on a two part procedure consistent with the requirements of SFAS 142. The first test consists of determining the fair value of the reporting unit and comparing it to the carrying value of the reporting unit. If the carrying value of the reporting unit exceeds the fair value of the reporting unit, a second test is performed. In step two, the implied fair value of the goodwill (which is the excess of the fair value of the reporting unit over the fair value of the net assets) is compared to the carrying value of the goodwill. An impairment loss is recognized for any excess value of goodwill over the implied value. We determined the Company's reporting unit by analyzing geographic region as management evaluates the Company's performance in this manner. We identified five separate and distinct operating units for the testing requirements of SFAS 142. In 2005 and

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2004, no charges to operations resulted from management's goodwill impairment evaluation.

Concentrations of Credit Risk - Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, cash equivalents and accounts receivable. As of December 31, 2005, the Company had cash balances at certain financial institutions in excess of federally insured limits. However, the Company does not believe that it is subject to unusual credit risk beyond the normal credit risk associated with commercial banking relationships.

Credit risk is generally diversified due to the large number of customers that make up the Company's customer base and their geographic dispersion resulting from three acquisitions in 2002. The Company performs an ongoing credit evaluation of its customers. In 2005 billings to one customer represented 15% of the Company's consolidated revenue or 16% of revenue from the Integration segment. Revenues to local government agencies were 39% and 20% of total revenue for the years ended December 31, 2005 and 2004, respectively.

There are a few vendors from whom we obtain devices and software for specific access control, imaging, remote transmission, smart key and mobile applications. The loss of any one of these companies as suppliers could have a materially adverse impact on our business, financial

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

condition and results of operations if we are unable to develop or acquire new technologies from other sources. We believe there are alternative vendors to source such products.

Timely vendor deliveries of equipment meeting our quality control standards from all suppliers are also important to our business because each installed system requires the integration of a variety of elements to be fully functional. The failure to deliver any component when required, in operating condition, can delay the project, triggering contract penalties, delay in progress payments and may result in cancellation of the project.

Income Taxes - Deferred taxes are provided on the asset and liability method whereby assets and liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the amounts reported for financial statement purposes and corresponding amounts for tax purposes. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Fair Value of Financial Instruments - The carrying amounts of the Company's financial instruments, which include cash equivalents, accounts receivable, accounts payable, accrued expenses, short and long-term debt, approximate their fair values as of December 31, 2005.

Advertising Costs - The Company expenses advertising cost when the advertisement occurs. Total advertising expenses amounted to approximately

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\$40,346 and \$44,466 for the years ended December 31, 2005 and 2004, respectively.

Stock Based Compensation - In December 2002, the FASB issued SFAS No. 148 "Accounting for Stock Based Compensation - Transition and Disclosure". SFAS No. 148 provides alternative methods of transitions to SFAS No 123's fair value method of accounting for stock based employee compensation, but does not require companies to use fair value method. It also amends the disclosure provisions of SFAS No. 123 and APB No.25 to require, in the summary of significant policies, the effect of an entity's accounting policy with respect to stock based employee compensation on reported net income and earnings per share in annual and interim financial statements. The provision of this statement is effective for fiscal years ending after December 15, 2002, and interim reporting periods beginning after December 15, 2002. Accordingly, the fair value of all options granted on and after January 1, 2003 is to be charged against income over the vesting period. In 2005, the company charged \$191,106 to operations for the fair value of those options granted subsequent to January 1, 2003. Those issued prior to adoption are accounted for under the intrinsic value method in accordance with APB No. 25. The Company adopted the perspective method as permitted by SFAS No. 148 on January 1, 2003.

Warranty - The Company offers warranties on all products, including parts and labor that ranges from one to three years, depending upon the product. For products made by others, the Company passes along the manufacturer's warranty to the end user. The Company charges

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

operations with warranty expenses as incurred. For the years ended December 31, 2005 and 2004, warranty expense was approximately \$49,231 and \$152,500, respectively.

Net Income Per Share - The computation of basic earnings per share is based upon the weighted average number of shares of common stock outstanding during the period. The computation of diluted earnings per share includes the dilutive effects of common stock equivalents of options and warrants.

Segment Information - FASB issued Statement of Financial Accounting Standards No. 131, "Disclosure about Segments of an Enterprise and Related Information" ("Statement 131"), that establish standards for the reporting by public business enterprises of financial and descriptive information about reportable operating segments in annual financial statements and interim financial reports issued to shareholders. The Company has identified two operating segments in which it operates; Security Systems Integration ("Integration") and Specialty Products and services ("Specialty"). The Integration segment provides design, installation and support services for a wide variety of security, communications and control systems. The Company specializes in turnkey systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. In October 2005 the Company acquired Securus, Inc. a provider of security system integration with offices in Denver and Colorado Springs Colorado. The Specialty Products and Services segment ("Specialty") includes the Company's digital mobile recording business, Viscom Products, Inc. and its emergency preparedness planning programs business. In April 2004, the Company acquired Airorlite

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Communications, Inc. ("Airorlite") which is included within the Specialty segment. Airorlite specializes in designing, manufacturing and maintaining wireless communications equipment used to enhance and extend emergency radio frequency services and cellular communication for both fixed and mobile applications. Each of the Company's segments market nationwide with an emphasis in the New Jersey/New York, Southern California, Dallas, Phoenix and Denver metropolitan areas. Customers are primarily medium and large businesses and governmental agencies. The Company derives a majority of its revenues from project installations and to a smaller extent, maintenance service revenue.

New Accounting Pronouncements - In May 2005, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections," ("SFAS No. 154") which replaces Accounting Principles Board Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements - An Amendment of APB Opinion No. 28". SFAS No. 154 provides guidance on accounting for and reporting changes in accounting principle and error corrections. SFAS No. 154 requires that changes in accounting principle be applied retrospectively to prior period financial statements and is effective for fiscal years beginning after December 15, 2005. The Company does not expect SFAS No. 154 to have a material impact on its financial position, results of operations, or cash flows.

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

2. ACCOUNTS RECEIVABLE

Accounts receivable consisted of the following at December 31, 2005:

|  |              |
|--|--------------|
| Completed contracts including retentions | \$ 3,189,288 |
| Contracts in progress                    | 6,894,444    |
| Current retentions                       | 662,611      |
|  | -----        |
|  | 10,746,343   |
| Less allowance for doubtful accounts     | 811,389      |
|  | -----        |
|  | \$ 9,934,954 |
|  | =====        |

At December 31, 2005 one customer represented 12.5% of the net accounts receivable.

3. COSTS AND BILLINGS ON UNCOMPLETED CONTRACTS

Costs and billing on uncompleted contracts at December 31, 2005 consisted of the following:

|  |               |
|--|---------------|
| Cost incurred on uncompleted contracts | \$ 32,014,993 |
| Billings on uncompleted contracts      | 30,081,008    |
|  | -----         |
|  | \$ 1,933,985  |
|  | =====         |

Included in accompanying Balance Sheets under the following captions:



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|  |              |
|--|--------------|
| Costs in Excess of Billings on Uncompleted Contracts | \$ 3,110,798 |
| Billing in excess of costs on Uncompleted Contracts  | 1,176,813    |
|  | -----        |
|  | \$ 1,933,985 |
|  | =====        |

4. INVENTORIES

Inventories consist of the following at December 31, 2005:

|                 |              |
|-----------------|--------------|
| Component Parts | \$ 144,028   |
| Finished Goods  | 1,083,843    |
|                 | -----        |
|                 | \$ 1,227,871 |
|                 | =====        |

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

5. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31, 2005:

|                               |              |
|-------------------------------|--------------|
| Office Equipment              | \$ 949,148   |
| Demo and Testing Equipment    | 111,485      |
| Automotive Equipment          | 1,414,647    |
| Computer Equipment            | 960,134      |
| Machinery and Equipment       | 209,191      |
| Leasehold Improvements        | 100,071      |
|                               | -----        |
|                               | 3,744,676    |
| Less Accumulated Depreciation | 2,621,115    |
|                               | -----        |
|                               | \$ 1,123,561 |
|                               | =====        |

Depreciation expense was approximately \$488,899 and \$340,268 for the years ended December 31, 2005 and December 31, 2004, respectively.

Equipment under capital leases included in Property and Equipment at December 31, 2005 is as follows:

|                               |            |
|-------------------------------|------------|
| Automotive equipment          | \$ 309,128 |
| Less accumulated depreciation | 99,306     |
|                               | -----      |
|                               | \$ 209,822 |
|                               | =====      |

6. GOODWILL

Goodwill, as of December 31, 2005, consisted of the following:

|                                   |              |
|-----------------------------------|--------------|
| National Safe of California       | \$ 1,267,580 |
| Photo Scan Systems                | 346,000      |
| Henry Bros. Electronics (Arizona) | 317,114      |

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|                               |              |
|-------------------------------|--------------|
| Airolite Communications, Inc. | 203,650      |
| Securus, Inc.                 | 770,000      |
|                               | -----        |
|                               | \$ 2,904,344 |
|                               | =====        |

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

7. INTANGIBLE ASSETS

Intangible assets consist of the following:

|                                | Acquired<br>Customer<br>List | Service<br>Rights | Covenant<br>Not to<br>Compete | Trade<br>Name | Total<br>Amortizable<br>Intangibles |
|--------------------------------|------------------------------|-------------------|-------------------------------|---------------|-------------------------------------|
|                                | -----                        | -----             | -----                         | -----         | -----                               |
| Gross carrying value:          |                              |                   |                               |               |                                     |
| December 31, 2004              | \$ 464,201                   | \$ 494,108        | \$ 228,920                    |               | \$ 1,187,229                        |
| Additions                      | 260,000                      |                   |                               | 80,000        | 340,000                             |
| Impairment charge              | (17,742)                     | (36,559)          |                               |               | (54,301)                            |
|                                | -----                        | -----             | -----                         | -----         | -----                               |
| December 31, 2005              | 706,459                      | 457,549           | 228,920                       | 80,000        | 1,472,928                           |
|                                | -----                        | -----             | -----                         | -----         | -----                               |
| Accumulated amortization:      |                              |                   |                               |               |                                     |
| December 31, 2004              | (71,040)                     | (100,527)         | (138,924)                     |               | (310,491)                           |
| Amortization                   | (38,879)                     | (54,829)          | (60,636)                      | (4,000)       | (158,344)                           |
| Impairment charge              | 4,651                        | 4,651             |                               |               | 9,302                               |
|                                | -----                        | -----             | -----                         | -----         | -----                               |
| December 31, 2005              | (105,268)                    | (150,705)         | (199,560)                     | (4,000)       | (459,533)                           |
|                                | -----                        | -----             | -----                         | -----         | -----                               |
| Net Carrying Value             | \$ 601,191                   | \$ 306,844        | \$ 29,360                     | \$ 76,000     | \$ 1,013,395                        |
|                                | =====                        | =====             | =====                         | =====         | =====                               |
| Weighted average life in years | 11                           | 6                 | 3                             | 5             | 6                                   |

Amortization expense was \$158,344 and \$150,588 for the years ended December 31, 2005 and December 31, 2004, respectively.

Future amortization expense for each of the next five years ended December 31 follows:

|      |           |
|------|-----------|
| 2006 | \$166,227 |
| 2007 | 163,560   |
| 2008 | 163,560   |
| 2009 | 111,972   |
| 2010 | 111,972   |

8. LONG-TERM DEBT

On June 30, 2005, Company entered into a loan agreement (the "Loan

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Agreement") with Hudson United Bank ("Hudson") pursuant to which Hudson extended a \$4 million two-year credit facility (the "Revolving Loan"), to the Company and refinanced \$1 million of existing indebtedness to Hudson into a five year term loan (the "Term Loan").

Advances under the Revolving Loan may be used to finance working capital and acquisitions. Interest is paid monthly in arrears at Hudson's prime rate (7.25% at December 31, 2005) through May 1, 2007 when all amounts outstanding under the Revolving loan is due. At December 31, 2005 there was no balance outstanding under the Revolving Loan.

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The Term Loan provides for the payment of sixty equal monthly installments of principal and interest in the amount of \$19,729.65 commencing July 30, 2005 and continuing thru June 30, 2010. Interest under the Term Loan is 6.75%.

The Company is required to maintain certain financial and reporting covenants under the terms of the Loan Agreement.

Long-term debt included of the following balances at December 31, 2005:

|  |            |
|--|------------|
| Term loan at 6.75% interest, payable in monthly installments thru June 30, 2010                                    | \$ 724,829 |
| Capitilzed lease obligations due in monthly installments of \$9,083, including interest ranging from 4.25% to 5.0% | 246,215    |
| Other miscellaneous debt   | 53,583     |
|  | -----      |
|  | 1,024,627  |
| Less current portion   | 296,666    |
|  | -----      |
|  | \$ 727,961 |
|  | =====      |

The weighted average prime interest rates for the years ended December 31, 2005 and 2004 were 6.4% and 4.6%, respectively.

Future minimum lease payments for assets under capital leases for the years ended

|   |              |            |
|---|--------------|------------|
|   | December 31, |            |
|   | -----        |            |
|   | 2006         | \$ 105,925 |
|   | 2007         | 105,925    |
|   | 2008         | 63,542     |
|   | 2009         | 16,841     |
|   |              | -----      |
| Total                                       |              | 292,233    |
| Amount representing interest                |              | 46,018     |
|   |              | -----      |
| Present Value of net minimum lease payments |              | \$ 246,215 |
|   |              | =====      |

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

Aggregate maturities of all outstanding debt for each of the years ended:

| December 31, |            |
|--------------|------------|
| -----        |            |
| 2006         | \$ 296,666 |
| 2007         | 314,039    |
| 2008         | 283,021    |
| 2009         | 130,901    |

9. INCOME TAXES

The tax provision for the years ended December 31, consists of the following:

|                               | 2005       | 2004       |
|-------------------------------|------------|------------|
|                               | -----      | -----      |
| Federal                       |            |            |
| Current                       | \$ 854,857 | \$ 5,117   |
| Benefit of net operating loss | (816,000)  |            |
| Deferred                      | 670,500    | 122,704    |
| State                         |            |            |
| Current                       | 136,945    | 115,268    |
| Benefit of net operating loss | (41,000)   |            |
| Deferred                      | 117,971    | 30,676     |
|                               | -----      | -----      |
|                               | \$ 923,273 | \$ 273,765 |
|                               | =====      | =====      |

Deferred income tax assets and liabilities at December 31, 2005 are comprised of the following:

|                                 |            |
|---------------------------------|------------|
| Deferred tax asset:             |            |
| Allowance for doubtful accounts | \$ 318,730 |
| Accrued absences                | 26,361     |
| Accrued warranty                | 164,613    |
| Depreciation                    | 16,426     |
| Inventory                       | 10,188     |
| Stock compensation              | 185,104    |
| Intangible assets               | 55,000     |
| Net operating loss carryforward | 210,107    |
|                                 | -----      |
| Total deferred tax asset        | 986,529    |
|                                 | -----      |
| Short-term                      | 931,529    |
| Long-term                       | 55,000     |
| Deferred tax liability:         |            |
| Cash to accrual basis           | (16,199)   |
| Intangible assets               | (226,028)  |
|                                 | -----      |

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|                              |            |
|------------------------------|------------|
| Total deferred tax liability | (242,227)  |
|                              | -----      |
| Short-term                   | (16,199)   |
|                              | -----      |
| Long-term                    | (226,028)  |
|                              | -----      |
| Net deferred tax asset       | \$ 744,302 |
|                              | =====      |

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

The Company has a Federal net operating loss carryforward of approximately \$517,505 that expires in 2023.

The provision for income taxes reported for the years ended December 31, differs from that computed using the United States statutory tax rate of 34% due to the following:

|   | 2005       | 2004       |
|---|------------|------------|
|   | -----      | -----      |
| Provision for taxes computed using the statutory rate | \$ 737,275 | \$ 108,048 |
| State taxes, net of federal tax benefit               | 95,660     | 69,916     |
| Permanent differences                                 | 14,782     | 15,066     |
| Other   | 75,556     | -          |
| Revised estimate to deferred tax                      | -          | 71,401     |
| Additional state income tax from prior year           | -          | 9,334      |
|   | -----      | -----      |
| Provision for income taxes                            | \$ 923,273 | \$ 273,765 |
|   | =====      | =====      |

10. INCENTIVE STOCK OPTION PLAN

The Company has a Stock Option Plan (the "1999 Plan"), for the benefit of employees of the Company, under which options to purchase up to a maximum of 500,000 shares of its common stock may be issued.

The maximum term of any option is ten years, and the option price per share may not be less than the fair market value of the Company's shares at the date the option is granted. However, options granted to persons owning more than 10% of the voting shares will have a term not to exceed five years, and the option price will not be less than 110% of fair market value. Options granted to an optionee will usually vest 33 1/3% annually, beginning on the first anniversary of the option grant, subject to the discretion of the Compensation Committee of the Board of Directors.

The 1999 Plan will terminate on December 23, 2009 or on such earlier date as the Board of Directors may determine. Any option outstanding at the termination date will remain outstanding until it expires or is exercised in full, which ever occurs first.

On May 10, 2002, the Board of Directors approved the 2002 Incentive Stock Option Plan (the "2002 Plan"), which the shareholders subsequently approved on October 28, 2002. The 2002 Plan allows the granting of incentive stock options

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or non-qualified stock options to the Company's employees, directors and consultants, up to a maximum purchase of 230,000 shares of its common stock. All stock options granted under the 2002 Plan will be exercisable at such time or times and in

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

such installments, if any, as our Compensation Committee or the Board may determine and expire no more than ten years from the date of grant. The 2002 Plan will terminate on May 9, 2012, or such earlier date as the Board of Directors may determine. Any option outstanding at the termination date will remain outstanding until it expires or is exercised in full, whichever occurs first. The exercise price of the stock option will be at fair market value. Vesting is at the discretion of the Compensation Committee. The 2002 Plan allows for immediate vesting if there is a change of control. As of December 31, 2005, a total of 240,100 options are available for future grant under both the 1999 Plan and the 2002 Plan.

A summary of stock option activity under the 1999 Plan and the 2002 Plan are as follows:

|                    | Shares<br>subject to<br>options | Weighted<br>average<br>exercise price | Shares<br>subject to<br>exercisable<br>options |
|--------------------|---------------------------------|---------------------------------------|--|
|                    | -----                           | -----                                 | -----  |
| December 31, 2003  | 223,200                         | \$ 6.51                               | 147,924  |
| Options granted    | 136,000                         | \$ 7.12                               |  |
| Options exercised  | (18,525)                        | \$ 6.66                               |  |
| Options terminated | (31,100)                        | \$ 6.91                               |  |
| December 31, 2003  | 309,575                         | \$ 6.79                               | 192,457  |
| Options granted    | 205,000                         | \$ 4.87                               |  |
| Options exercised  | --                              | --                                    |  |
| Options terminated | (43,200)                        | \$ 6.84                               |  |
| December 31, 2004  | 471,375                         | \$ 5.95                               | 240,375  |
|                    | =====                           |                                       |  |

The following tables summarize information about stock options outstanding under the 1999 Plan and 2002 Plan as of December 31, 2005:

| Range of<br>Exercise Prices | Options Outstanding                   |   |  | Options Exercisable                      |  |
|-----------------------------|---------------------------------------|---|--|--|--|
|                             | Number<br>Outstanding<br>At Dec. 2005 | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Weighted<br>Average<br>Exercise<br>Price | Number<br>Exercisable<br>At<br>Dec. 2005 | Weighted<br>Average<br>Exercise<br>Price |
| \$ 4.65-\$7.95              | 471,375                               | 4.6   | \$ 5.95                                  | 240,375                                  | \$ 6.70                                  |

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## HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

Deferred compensation cost is being amortized over the vesting period of up to five years. The fair value of the Company's stock option awards was estimated assuming no expected dividends and the following weighted-average assumptions for the years ended December 31:

|                          | Options |       |
|--------------------------|---------|-------|
|                          | 2005    | 2004  |
| Expected Life (years)    | 3       | 3     |
| Expected volatility      | 33.0%   | 20.7% |
| Risk-free interest rates | 3.9%    | 3.3%  |

The weighted average fair value per share of options granted during 2005 and 2004 was \$1.77 and \$1.82, respectively.

### 11. STOCKHOLDERS' EQUITY

In connection with the acquisition of Securus Inc. on October 10, 2005, the Company issued an aggregate of 150,001 shares of its common stock of which 150,001 are being held in escrow pursuant to the stock purchase escrow agreement between the Company and the selling shareholders of Securus, Inc. The issuance of the shares of restricted stock in connection with the aforementioned acquisition was made in reliance upon the exemption provided in section 4(2) of the Securities Act of 1933, as amended.

ACI Acquisition Corporation, a wholly-owned subsidiary of the Company, purchased all of the issued and outstanding stock of Airorlite Communications, Inc ("Airorlite") effective April 1, 2004. The purchase consisted of \$200,000 in cash and 37,000 shares of the Company's common stock, valued at \$266,400. ACI Acquisition Corporation was subsequently renamed Airorlite Communication's Inc. These shares were issued in reliance on the exemption provided by Section 4(2) of the Securities Act of 1933, as amended, regarding transactions not involving a public offering.

On July 28, 2004, the Company completed a \$3,319,998 private placement of its common stock to certain qualified institutional investors. Under the terms of the agreement, the Company sold an aggregate of 553,333 shares of common stock for \$6.00 per share. The Company also has granted the investors a warrant to acquire 138,333 shares of common stock at an exercise price of \$7.60 per share, exercisable for a period commencing six months after the date of issuance through the fifth anniversary of the issuance. In addition, the Placement Agent received a commission of 8% of the proceeds plus expenses and was issued a warrant to acquire 55,333 shares of common stock with the same terms as those issued to the institutional investors. After expenses, the net proceeds of the transaction were \$2,958,058. The Company filed a registration statement with the SEC covering the resale of the shares sold under this private placement and the shares issuable upon the exercise of the warrants on August 29, 2004, which statement was declared effective on September 7, 2004.

On December 31, 2003, the Board of Directors authorized the issuance of 52,550 shares of restricted stock to employees. These shares were valued at \$294,280 and the Company included this

HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

expense in the Consolidated Statements of Operations for 2003. On November 5, 2004, the Company's shareholders approved the issuance of these shares. These shares were restricted from resale for a one year period and were issued on January 3, 2005.

On November 1, 2001, the Company entered into an agreement with The Wall Street Group, Inc. ("WSG") to provide financial public relations services to the Company (the "Agreement"). Under the Agreement, WSG was paid a monthly fee and reimbursed out-of-pocket expenses, and earned options for the purchase of the Company's common stock. The Agreement also provided WSG with the right to have the shares issued under the Agreement, registered for sale under the Securities Act of 1933. Throughout the term of the Agreement until its termination on April 6, 2003, Wall Street Group earned options for the purchase of up to 45,996 shares of the Company's common stock having an average exercise price of \$6.99 per share. These options are exercisable with 40,000 expiring in November 2006 and the balance in November 2007. The options were not granted as part of the Company's 1999 Plan or 2002 Plan.

Holders of common stock are entitled to one vote for each share held on all matters submitted for a vote of stockholders and do not have cumulative voting rights. Apart from preferences that may be applicable to any shares of preferred stock outstanding at the time, holders of our common stock are entitled to receive dividends ratably, if any, as may be declared from time to time by our board of directors out of funds legally available. Upon the liquidation, dissolution or winding up of the Company, the holders of common stock are entitled to receive ratably the net assets available after the payment of all liabilities and liquidation preferences on any outstanding preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights, and there are no redemption or sinking fund provisions applicable to the common stock.

Treasury Stock - On November 5, 2004, a resolution of the Board of Directors provided for the return of shares held in treasury unissued shares.

Preferred Stock - Our board of directors is authorized, without stockholder approval, to issue up to 2,000,000 shares of preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions of these shares, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, and to fix the number of shares constituting any series and the designations of these series. These shares may have rights senior to our common stock. The issuance of preferred stock may have the effect of delaying or preventing a change in control. The issuance of preferred stock could decrease the amount of earnings and assets available for distribution to the holders of our common stock or could adversely affect the rights and powers, including voting rights, of the holders of our common stock. At present, we have no plans to issue preferred stock in the foreseeable future.

Warrants - In connection with the Company's private placement of its common stock to certain qualified institutional investors in July 2004 (as noted above), such investors were issued warrants to acquire 138,333 shares of common stock at an exercise price of \$7.60 per share, exercisable for a period



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commencing six months after the date of issuance through the fifth anniversary of the

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

issuance. In addition, the Placement Agent was issued warrants to acquire 55,333 shares of common stock with the same terms as those issued to the institutional investors. These warrants will expire January 27, 2010.

A total of 951,137 common shares are reserved for exercise of employee stock options and warrants as of December 31, 2005.

#### 12. COMMITMENTS

Leases - The Company leases its office and warehouse facilities under operating leases that expire through 2010. Future minimum rental payments, under non-cancelable leases as of December 31, 2005, are as follows:

|      |            |
|------|------------|
| 2006 | \$ 396,000 |
| 2007 | 119,000    |
| 2008 | 114,000    |
| 2009 | 115,000    |
| 2010 | 101,000    |

Rent expense under operating leases were approximately \$421,000 and \$381,000 for the years ended December 31, 2005 and 2004, respectively.

#### 13. EMPLOYEE BENEFIT PLAN

As of January 1, 2003, the Company sponsored a 401-K plan, including discretionary profit sharing (the "401-K Plan"). The Company may match up to three percent of qualifying employees' compensation when contributed to the 401-K Plan. As of September 1, 2003, the Company decided to discontinue matching employee contributions to the 401-K Plan but may resume discretionary matches in the future. The Company's contributions to the employees' accounts vest equally over three years and the employee contribution to their own account vests immediately. There were no Company matching contributions to the 401-K plan during 2005 or 2004.

#### 14. RELATED PARTIED TRANSACTIONS

The Company paid consulting fees of approximately \$3,000 for the year ended December 31, 2004, to a corporation that had a former Director of the Company as an officer.

#### 15. CONTINGENT LIABILITIES

From time to time, the Company is subject to various claims with respect to matters arising out of the normal course of business. In management's opinion, none of these claims is likely to have a material affect on the Company's consolidated financial statements.

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### HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements (continued)

#### 16. SEGMENT DATA

Selected information by business segment is presented in the following tables for the years ended December 31:

|                        | 2005          | 2004          |
|------------------------|---------------|---------------|
|                        | -----         | -----         |
| Revenue                |               |               |
| Integration            | \$ 38,848,317 | \$ 26,255,044 |
| Specialty              | 3,890,952     | 3,734,038     |
| Inter-segment          | (583,081)     | (263,664)     |
|                        | -----         | -----         |
| Total revenue          | \$ 42,156,188 | \$ 29,725,418 |
|                        | =====         | =====         |
| Operating Profit       |               |               |
| Integration            | \$ 2,928,282  | \$ 630,433    |
| Specialty              | 574,920       | 1,084,167     |
| Corporate expenses     | (1,395,393)   | (1,315,399)   |
|                        | -----         | -----         |
| Total operating profit | \$ 2,107,809  | \$ 399,201    |
|                        | =====         | =====         |

Selected balance sheet information by business segment is presented in the following table as of December 31, 2005:

|              |               |
|--------------|---------------|
| Total Assets |               |
| Integration  | \$ 18,972,912 |
| Specialty    | 2,816,577     |
| Corporate    | 2,861,147     |
|              | -----         |
| Total assets | \$ 24,650,636 |
|              | =====         |

#### 17. ACQUISITIONS

On October 10, 2005 we acquired Securus, Inc. ("Securus") a privately held company established in 1969 having offices in Denver and Colorado Springs, Colorado. Securus designs, installs and maintains physical electronic security systems for government and commercial enterprises. Securus will be included as part of our Integration business segment.

Under the terms of the Stock Purchase Agreement with the Securus shareholders, pursuant to which we acquired all of the issued and outstanding stock of Securus, we paid an aggregate purchase price of \$1,110,000 comprised of \$770,000 cash to the selling shareholders, the assumption and subsequent repayment of \$240,000 of Securus bank debt and incurred approximately \$100,000 in transactions costs. We also issued and placed into escrow 150,001 shares of our common stock which may be earned out through December 31, 2010 based upon the aggregate value of the earnings

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

before interest and tax ("EBIT") to \$2,960,000. In addition, the selling shareholders may earn an additional amount of up to \$200,000 based upon one third of the aggregate EBIT earned in excess of \$2,960,000 thru December 31, 2010.

The purchase price was allocated to the assets acquired and liabilities assumed based upon the estimated fair market values as follows:

|   |    |             |
|---|----|-------------|
| Cash and cash equivalents                         | \$ | 25,472      |
| Accounts receivable-net                           |    | 379,886     |
| Inventory   |    | 89,169      |
| Costs in excess of billings and estimated profits |    | 314,322     |
| Other assets                                      |    | 300,581     |
|   |    | -----       |
| Total current assets                              |    | 1,109,430   |
|   |    | -----       |
| Property and equipment-net                        |    | 28,793      |
| Amortizable intangible assets:                    |    |             |
| Customer relationships (9 year life)              |    | 260,000     |
| Trademark and trade name (5 year life)            |    | 80,000      |
| Deferred tax asset                                |    | 156,880     |
| Other assets                                      |    | 56,581      |
|   |    | -----       |
| Total assets                                      |    | 1,691,684   |
| Total current liabilities                         |    | (1,091,287) |
| Non current deferred revenue                      |    | (260,397)   |
|   |    | -----       |
| Net assets acquired                               | \$ | 340,000     |
|   |    | =====       |

The excess purchase price of \$770,000 was assigned to goodwill.

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HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES  
Notes to the Consolidated Financial Statements (continued)

Selected unaudited pro forma consolidated statements of income data for each of the years ended December 31, 2005 and 2004 assuming that Securus was included in our results from the beginning of 2004 is as follows:

|            | 2005          | 2004          |
|------------|---------------|---------------|
|            | -----         | -----         |
| Revenue    | \$ 45,888,287 | \$ 34,721,320 |
| Net income | \$ 1,187,156  | \$ (217,517)  |

Earnings per share:

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|         |    |      |    |        |
|---------|----|------|----|--------|
| Basic   | \$ | 0.21 | \$ | (0.04) |
| Diluted | \$ | 0.20 | \$ | (0.04) |

Weighted average common shares:

|         |           |           |
|---------|-----------|-----------|
| Basic   | 5,739,398 | 5,411,964 |
| Diluted | 5,889,399 | 5,561,965 |

The pro forma information is for illustrative purposes only, and does not necessarily indicate what the operating results of the combined companies would be had the acquisition actually occurred at the beginning of 2004, nor does it necessarily indicate the company's future operating results.

The above pro forma income data was prepared assuming that the acquisition took place on January 1, 2004 and gives effect to the following items: (i) the amortization of intangibles using there assumed useful life, (ii) interest expense at 5% (the average prime rate for the period) on the purchase price less the \$240,000 of refinanced acquired debt from the beginning of the period through the transaction date, (iii) the tax benefit on items (i) and (ii) using a 46% effective tax rate.

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EXHIBIT INDEX

The following exhibits are filed herewith as part of this Report on Form 10-KSB:

| Exhibit<br>Number | Description of Document   |
|-------------------|---|
| 3.1               | -- Certificate of Incorporation of the Company .....  |
| 3.2               | -- By-laws of the Company .....   |
| 3.3               | -- Certificate of Amendment of the Certificate of Incorporation of the<br>Company, filed on July 5, 2001 .....  |
| 3.4               | -- Certificate of Amendment of the Certificate of Incorporation of the<br>Company, filed on August 28, 2001 .....   |
| 4.1               | -- Specimen Common Stock Certificate of the Company .....   |
| 4.2               | -- Underwriter's Warrant Agreement .....  |
| 10.1              | -- 2002 Stock Option Plan .....   |
| 10.2              | -- Employment Agreement between the Company and James E. Henry .....  |
| 10.3              | -- Employment Agreement between the Company and Irvin F. Witcosky .....   |
| 10.4              | -- Employment Agreement between the Company and Louis Massad .....  |
| 10.5              | -- 1999 Incentive Stock Option Plan and form of Stock Option Agreement .....  |
| 10.6              | -- Amendment to Employment Agreement between the Company and Louis Massad .....   |
| 10.7              | -- Office Lease between the Company and Midland Holding Co., Inc. ....  |
| 10.8              | -- Office Lease between the Company and Eagle-DFW, Inc. ....  |
| 10.9              | -- Amendment to Employment Agreement between the Company and James E. Henry .....   |
| 10.10             | -- Amendment to Employment Agreement between the Company and Irvin F. Witcosky .....  |
| 10.11             | -- Agreement between the Company and Administaff, Inc. ....   |
| 14.1              | -- Code of Ethics .....   |
| 21.1              | -- List of Subsidiaries .....   |
| 31.1              | -- Certification of Chief Executive Officer pursuant to Rule 13a- 14 (a) or<br>Rule 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley<br>Act of 2002 ..... |
| 31.2              | -- Certification of Chief Operating Officer pursuant to Rule 13a- 14 (a) or<br>Rule 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley                      |

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|         |   |
|---------|---|
|         | Act of 2002 .....   |
| 31.3 -- | Certification of Chief Financial Officer pursuant to Rule 13a- 14(a) or Rule 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 ..... |
| 32 --   | Section 1350 Compliance .....   |

(1) Incorporated by reference to the Registration Statement on Form SB-2 File No. 333-94477, filed with the Securities and Exchange Commission on January 12, 2002(The "Registration Statement").

(2) Incorporated by reference to Amendment No. 4 to the Registration Statement filed with the Securities and Exchange Commission on September 25, 2001.

(3) Incorporated by reference to Amendment No. 6 to the Registration Statement filed with the Securities and Exchange Commission on November 13, 2001.

(4) Incorporated by reference to Post-Effective Amendment No. 1 to the Registration Statement filed on February 8, 2001.

(5) Incorporated by reference to the Company's Definitive Proxy on Form 14A, filed with the Securities and Exchange Commission on September 27, 2002.

(6) Incorporated by reference to the Company's Annual Report on 10-KSB for the Company for the Year Ended December 31, 2003 filed with the Securities and Exchange Commission on April 1, 2004.

(7) Incorporated by reference to the Company's Annual Report on 10-KSB for the Company for the Year Ended December 31, 2004 filed with the Securities and Exchange Commission on March 28, 2005.

(\*) Filed herewith.