

Henry Bros. Electronics, Inc.  
Form 10-Q  
October 18, 2007

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

Form 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15 (D) OF THE SECURITIES AND  
EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2007

OR

TRANSITION REPORT UNDER SECTION 13 OR 15 (D) OF THE SECURITIES AND  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No. 05-62411

**Henry Bros. Electronics, Inc.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

22-3690168  
(I.R.S. Employer  
Identification No.)

**17-01 Pollitt Drive  
Fair Lawn, New Jersey 07410**

(address of principal executive offices) (Zip Code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's Common Stock, as of the latest practicable date: 5,926,065 shares of common stock, \$.01 par value per share, as of September 30, 2007.



**INDEX**

| <b>Part I</b>  | <b>Financial Information</b>  | <b>Page</b> |
|----------------|---|-------------|
| Item 1.        | Condensed Financial Statements<br>Condensed Consolidated Balance Sheets as of March 31, 2007 (Unaudited) and<br>December 31, 2006 (Audited) | 2           |
|                | Condensed Consolidated Statements of Operations for the three months ended March<br>31, 2007 (Unaudited) and March 2006 (Unaudited)         | 3           |
|                | Condensed Consolidated Statements of Cash Flows for the three months ended March<br>31, 2007 (Unaudited) and March 2006 (Unaudited)         | 4           |
|                | Condensed Consolidated Statement of Changes in Stockholders' Equity for the three<br>months ended March 31, 2007 and 2006 (Unaudited)       | 5           |
|                | Notes to Condensed Consolidated Financial Statements  | 6-10        |
| Item 2.        | Management's Discussion and Analysis of Financial Condition and Results of<br>Operations  | 11-14       |
| Item 3.        | Quantitative and Qualitative Disclosures about Market Risk  | 14          |
| Item 4.        | Controls and Procedures   | 14-15       |
| <b>Part II</b> | <b>Other Information</b>  | <b>16</b>   |
| Item 1.        | Legal Proceedings   | 16          |
| Item 1A.       | Risk Factors  | 16          |
| Item 6.        | Exhibits  | 16          |
|                | SIGNATURES  | 17          |
|                | CERTIFICATIONS  | 18-24       |

**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | (Unaudited)<br>March 31,<br>2007 | (Audited)<br>December 31,<br>2006 |
|--|----------------------------------|-----------------------------------|
| <b>ASSETS</b>  |                                  |                                   |
| <b>CURRENT ASSETS</b>  |                                  |                                   |
| Cash and cash equivalents  | \$ 615,414                       | \$ 199,853                        |
| Accounts receivable-net of allowance for doubtful accounts   | 11,520,599                       | 13,628,358                        |
| Inventory  | 1,701,741                        | 1,707,933                         |
| Costs in excess of billings and estimated profits  | 4,447,268                        | 4,643,469                         |
| Deferred tax asset   | 1,459,620                        | 1,155,620                         |
| Retainage receivable   | 1,354,055                        | 1,390,468                         |
| Prepaid expenses and income tax receivable   | 959,590                          | 454,801                           |
| Other assets   | 289,968                          | 290,079                           |
| <b>Total current assets</b>  | <b>22,348,255</b>                | <b>23,470,581</b>                 |
| Property and equipment - net of accumulated depreciation   | 2,443,534                        | 2,402,394                         |
| Goodwill   | 3,316,530                        | 3,316,530                         |
| Intangible assets - net of accumulated amortization  | 1,380,747                        | 1,436,414                         |
| Deferred tax asset   | 644,545                          | 594,545                           |
| Other assets   | 153,595                          | 151,145                           |
| <b>TOTAL ASSETS</b>  | <b>\$ 30,287,206</b>             | <b>\$ 31,371,609</b>              |
| <b>LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>  |                                  |                                   |
| <b>CURRENT LIABILITIES</b>   |                                  |                                   |
| Accounts payable   | \$ 6,689,731                     | \$ 5,973,047                      |
| Accrued expenses   | 3,083,452                        | 4,786,203                         |
| Accrued taxes  | 58,375                           | 58,914                            |
| Billings in excess of costs and estimated profits  | 1,411,193                        | 1,167,259                         |
| Deferred income  | 373,620                          | 476,775                           |
| Current portion of long-term debt  | 559,570                          | 505,028                           |
| Deferred tax liability   | 249,365                          | 249,365                           |
| Other current liabilities  | 548,037                          | 252,881                           |
| <b>Total current liabilities</b>   | <b>12,973,343</b>                | <b>13,469,472</b>                 |
| Long-term debt, less current portion   | 3,646,472                        | 3,463,236                         |
| Deferred tax liability   | 428,283                          | 428,283                           |
| <b>TOTAL LIABILITIES</b>   | <b>17,048,098</b>                | <b>17,360,991</b>                 |
| <b>STOCKHOLDERS' EQUITY</b>  |                                  |                                   |
| Preferred stock, \$.01 par value; 10,000,000 shares authorized; no shares issued   | -                                | -                                 |
| Common stock, \$.01 par value; 10,000,000 shares authorized;<br>5,916,065 shares issued and outstanding in 2007 and 2006 | 59,161                           | 59,161                            |
| Additional paid in capital   | 17,284,205                       | 17,284,205                        |
| Deferred compensation  | (334,647)                        | (383,552)                         |
| Accumulated deficit  | (3,769,611)                      | (2,949,196)                       |
| <b>TOTAL EQUITY</b>  | <b>13,239,108</b>                | <b>14,010,618</b>                 |
| <b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>  | <b>\$ 30,287,206</b>             | <b>\$ 31,371,609</b>              |



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

|   | <b>(Unaudited)</b>                         |                   |
|---|--|-------------------|
|   | <b><u>Three months ended March 31,</u></b> |                   |
|   | <b>2007</b>                                | <b>2006</b>       |
|   |  | <b>(Restated)</b> |
| Revenue   | \$ 10,871,301                              | \$ 9,144,828      |
| Cost of revenue   | 8,715,125                                  | 6,206,653         |
| Gross profit  | 2,156,176                                  | 2,938,175         |
| Operating expenses:                                     |  |                   |
| Selling, general & administrative expenses              | 3,264,167                                  | 2,628,754         |
| Operating (loss) profit                                 | (1,107,991)                                | 309,421           |
| Interest income   | 6,941                                      | 180               |
| Other expense   | (259)                                      | -                 |
| Interest expense  | (70,457)                                   | (26,728)          |
| (Loss) income before tax expense                        | (1,171,766)                                | 282,873           |
| Tax expense (benefit)                                   | (351,351)                                  | 181,186           |
| Net (loss) income after taxes                           | \$ (820,415)                               | \$ 101,687        |
| <b><u>BASIC (LOSS) EARNINGS PER COMMON SHARE:</u></b>   |  |                   |
| Basic (loss) profit per common share                    | \$ (0.14)                                  | \$ 0.02           |
| Weighted average common shares                          | 5,749,964                                  | 5,742,064         |
| <b><u>DILUTED (LOSS) EARNINGS PER COMMON SHARE:</u></b> |  |                   |
| Diluted (loss) profit per common share:                 | \$ (0.14)                                  | \$ 0.02           |
| Weighted average diluted common shares                  | 5,749,964                                  | 5,904,177         |

The accompanying notes are an integral part of these statements

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

|  | (Unaudited)<br>Three months ended<br>March 31, |                    |
|--|--|--------------------|
|  | 2007   | 2006<br>(Restated) |
| Cash flows from operating activities:  |  |                    |
| Net (loss) income  | \$ (820,415)                                   | \$ 101,687         |
| Adjustments to reconcile net (loss) income from operations to net cash provided by (used in) operating activities: |  |                    |
| Depreciation and amortization  | 152,173  | 152,881            |
| Bad debt expense   | 21,576   | 120,500            |
| Provision for obsolete inventory   | 10,000   | 15,000             |
| Stock option expense   | 48,905   | 49,882             |
| Deferred income taxes  | (354,000)                                      | (8,774)            |
| Changes in operating assets and liabilities:   |  |                    |
| Accounts receivable  | 2,086,183                                      | (376,410)          |
| Inventories  | (3,808)  | (1,795)            |
| Costs in excess of billings and estimated profits  | 196,201  | (357,926)          |
| Retainage receivable   | 36,413   | (269,399)          |
| Other assets   | 111  | (36,444)           |
| Prepaid expenses and income tax receivable   | (504,789)                                      | (187,837)          |
| Accounts payable   | 716,684  | (898,251)          |
| Accrued expenses   | (1,702,751)                                    | 152,375            |
| Billings in excess of cost and estimated profits   | 243,934  | 168,833            |
| Deferred income  | (103,155)                                      | (13,503)           |
| Other Liabilities  | 295,156  | 20,500             |
| Net cash provided by (used in) operating activities  | 318,418  | (1,368,681)        |
| Cash flows from investing activities:  |  |                    |
| Purchase of property and equipment   | (95,222)                                       | (37,799)           |
| Net cash used in investing activities  | (95,222)                                       | (37,799)           |
| Cash flows from financing activities:  |  |                    |
| Proceeds from issuance of common stock - net of fees   |  | 30,996             |
| Net proceeds and (payments) from revolving bank lines  | 238,000  | -                  |
| Payments of bank loans   | (50,491)                                       | (53,994)           |
| Net repayments of other debt   | 32,095   | (3,977)            |
| Capitalized lease payments   | (27,240)                                       | (17,520)           |
| Net Cash provided by (used in) financing activities  | 192,364  | (44,495)           |
| Increase (decrease) in cash and cash equivalents   | 415,560  | (1,450,975)        |
| Cash and cash equivalents - beginning of period  | 199,854  | 2,177,686          |
| Cash and cash equivalents - end of period  | \$ 615,414                                     | \$ 726,711         |
| Supplemental disclosure of cash flow information:  |  |                    |
| Amount paid for the period for:  |  |                    |
| Interest   | \$ 71,828                                      | \$ 26,728          |
| Taxes  | \$ 175,500                                     | \$ 114,013         |
| Non-cash investing and financing activities:   |  |                    |
| Equipment financed   | \$ 42,425                                      | \$ 32,052          |

The accompanying notes are an integral part of these statements





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

|  | <b>Common Stock</b>    |                   | <b>Additional</b> | <b>Deferred</b> | <b>Retained</b> | <b>Total</b>  |
|--|------------------------|-------------------|-------------------|-----------------|-----------------|---------------|
|  | <b>par value \$.01</b> | <b>10,000,000</b> |                   |                 |                 |               |
|  | <b>Shares</b>          | <b>Amount</b>     | <b>Paid-in</b>    | <b>Comp-</b>    | <b>Earnings</b> |               |
|  |                        |                   | <b>Capital</b>    | <b>ensation</b> |                 |               |
| Balance at December 31, 2005<br>(Corrected)              | 5,889,399              | \$ 58,894         | \$ 16,956,008     | \$ (342,878)    | \$ (689,058)    | \$ 15,982,966 |
| Employee stock options exercised                         | 6,666                  | 66                | 30,930            |                 |                 | 30,996        |
| Amortization of value assigned to<br>stock option grants |                        |                   |                   | 49,882          |                 | 49,882        |
| Net income March 31, 2006                                |                        |                   |                   |                 | 101,687         | 101,687       |
| Balance at March 31, 2006                                | 5,896,065              | 58,960            | 16,986,938        | (292,996)       | (587,371)       | 16,165,531    |
| Balance at December 31, 2006                             | 5,916,065              | \$ 59,161         | \$ 17,284,205     | \$ (383,552)    | \$ (2,949,196)  | \$ 14,010,618 |
| Amortization of value assigned to<br>stock option grants |                        |                   |                   | 48,905          |                 | 48,905        |
| Net loss March 31, 2007                                  |                        |                   |                   |                 | (820,415)       | (820,415)     |
| Balance at March 31, 2007                                | 5,916,065              | \$ 59,161         | \$ 17,284,205     | \$ (334,647)    | \$ (3,769,611)  | \$ 13,239,108 |

The accompanying notes are an integral part of these statements

**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS (UNAUDITED)****1. Basis of Presentation**

Henry Bros. Electronics, Inc., (the "Company") and its subsidiaries, 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 turn-key systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. Through the Specialty Products and Services segment we provide emergency preparedness programs, mobile digital recording solutions and specialized radio frequency communication equipment and integration. Each of the Company's segments markets nationwide with an emphasis in the Arizona, California, Colorado, Maryland, New Jersey, New York, Texas and Virginia 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 the sales percentages by geographic location for the three months ended March 31, 2007 and 2006:

|                        | <b>2007</b> | <b>2006</b> |
|------------------------|-------------|-------------|
| New Jersey/New York    | 30%         | 45%         |
| California             | 29%         | 28%         |
| Texas                  | 4%          | 5%          |
| Arizona                | 9%          | 6%          |
| Colorado               | 9%          | 14%         |
| Virginia/Washington DC | 18%         | -           |
| Integration Segment    | 98%         | 98%         |
| Specialty Segment      | 2%          | 7%          |
| Inter-segment          |             | -5%         |
| Total                  | 100%        | 100%        |

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the three month period ended March 31, 2007, are not necessarily indicative of the results that may be expected for the full year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in the Company's Annual Report on Form 10-K for the fiscal period ended December 31, 2006.

As discussed in Item 4 on this Quarterly Report on Form 10-Q and as disclosed in the Company's Annual Report on Form 10-K for the fiscal period ended December 31, 2006, certain quarterly information in 2006 has been restated. The impact on the condensed consolidated operations for the three months ended March 31, 2006 follows:

**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS (UNAUDITED) □ (continued)****Three  
Months  
ended  
March 31,  
2006**

As

Reported:

|              |    |           |
|--------------|----|-----------|
| Revenue      | \$ | 9,155,078 |
| Gross profit |    | 2,995,705 |
| Net income   |    | 225,687   |

Earnings

per share:

|         |    |      |
|---------|----|------|
| Basic   | \$ | 0.04 |
| Diluted |    | 0.04 |

As Restated:

|              |    |           |
|--------------|----|-----------|
| Revenue      | \$ | 9,144,828 |
| Gross profit |    | 2,938,175 |
| Net income   |    | 101,687   |

Earnings

per share:

|         |    |      |
|---------|----|------|
| Basic   | \$ | 0.02 |
| Diluted |    | 0.02 |

**2 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, less the shares that may be repurchased with the funds received from their exercise and the effect of adding back unrecognized future stock compensation expense. Potentially dilutive securities are not included in earnings per share for the three months ended March 31, 2007, as their inclusion would be anti-dilutive.

**3. Stock Based Compensation**

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123(R) (FAS-123(R)), *Share-Based Payment*, which is a revision of Statement of Financial Accounting Standards No. 123 (FAS-123), *Accounting for Stock-Based Compensation*.

FAS-123(R) eliminates accounting for share-based compensation transactions using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 (APB-25), *Accounting for Stock Issued to Employees*, and requires instead that such transactions be accounted for using a fair-value-based method. The Company has elected to adopt the provisions of FAS-123(R) effective January 1, 2006, under the modified prospective transition method, in which compensation cost was recognized beginning with the effective date (a) based on the requirements of FAS-123R for all share-based payments granted after the effective date and (b) based on the requirements of FAS-123R for all awards granted to employees prior to the effective date of FAS-123R that remain unvested on the



**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS (UNAUDITED) □ (continued)**

effective date.

As permitted under FAS-123, the Company elected to follow Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock-based awards to employees through December 31, 2005. Accordingly, compensation cost for stock options and nonvested stock grants was measured as the excess, if any, of the market price of the Company's common stock at the date of grant over the exercise price.

With the adoption of FAS-123(R), the Company elected to amortize stock-based compensation for awards granted on or after the adoption of FAS-123R on January 1, 2006, on a straight-line basis over the requisite service (vesting) period for the entire award. For awards granted prior to January 1, 2006, compensation costs are amortized in a manner consistent with Financial Accounting Standards Board Interpretation No. 28 (FIN-28), *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. This is the same manner applied in the pro forma disclosures under FAS-123. Accordingly, the fair value of all options granted on and after January 1, 2003 is to be charged against income over the vesting period. For the three months ended March 31, 2007 and 2006 the Company charged \$57,525 and \$61,314, respectively to operations for 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.

**4. Long-Term Debt**

On June 30, 2005, the Company entered into a loan agreement (the "Loan Agreement") with TD Banknorth N.A., ("TD Banknorth", formerly known as Hudson United Bank) pursuant to which TD Banknorth extended a \$4 million two-year credit facility (the "Revolving Loan"), to the Company and refinanced \$1 million of existing indebtedness to TD Banknorth 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 TD Banknorth's prime rate (8.25% at March 31, 2007 and December 31, 2006) through May 1, 2008, when all amounts outstanding under the Revolving loan is due. The Revolving Loan was originally due May 1, 2007; however, in December 2006 TD Banknorth provided the Company a one year extension.

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 and is restricted from paying dividends under the terms of the Loan Agreement. The Company was not in compliance with certain of these bank covenants at March 31, 2007 and December 31, 2006. TD Banknorth provided

**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS (UNAUDITED) □ (continued)**

the Company with a waiver associated with the bank covenants in default on October 11, 2007. As a condition of the waiver, the Company agreed to grant TD Banknorth a first security interest on its accounts receivable.

Long-term debt included of the following balances:

|  | <b>(Unaudited)</b><br><b>March 31,</b><br><b>2007</b> | <b>(Audited)</b><br><b>December 31,</b><br><b>2006</b> |
|--|---|--|
| Term loan at 6.75% interest payable in monthly installments of \$19,730 thru June 30, 2010         | \$ 480,631  | \$ 531,122   |
| Revolving line at the prime rate of interest, payable in monthly installments thru May 1, 2008     | 3,085,897   | 2,847,897  |
| Corporate insurance financed at 8.49% in monthly installments thru October 1, 2007                 | 102,569   | 162,397  |
| Capitilzed lease obligations due in monthly installments, with interest ranging from 6.4% to 11.7% | 414,916   | 399,731  |
| Other miscellaneous debt   | 122,029   | 27,117   |
|  | 4,206,042   | 3,968,264  |
| Less: Current Portion  | (559,570)   | (505,028)  |
|  | \$ 3,646,472  | \$ 3,463,236   |

The weighted average prime interest rate for the quarters ended March 31, 2007 and 2006 were 8.25% and 7.42%, respectively.

**5. Segment Data**

Selected information by business segment is presented in the following tables:

|                                 | <b>Three months ended March 31,</b> |              |
|---------------------------------|-------------------------------------|--------------|
|                                 | <b>2007</b>                         | <b>2006</b>  |
| <b><u>Revenue</u></b>           |                                     |              |
| Total Integration               | \$ 10,643,774                       | \$ 8,986,111 |
| Specialty Products and Services | 227,527                             | 634,710      |
| Inter-segment                   | -                                   | (475,993)    |
| Total Revenue                   | \$ 10,871,301                       | \$ 9,144,828 |
| <b><u>Operating Profit</u></b>  |                                     |              |
| Total Integration               | \$ (279,616)                        | \$ 651,872   |
| Specialty Products and Services | (159,509)                           | (16,003)     |
| Corporate                       | (668,866)                           | (326,448)    |
| Total Operating Profit          | \$ (1,107,991)                      | \$ 309,421   |

Selected Balance sheet information by business segment is presented in the following table as of:

|                                 | <b>March 31, 2007</b> | <b>December 31,</b><br><b>2006</b> |
|---------------------------------|-----------------------|------------------------------------|
| <b><u>Total Assets</u></b>      |                       |                                    |
| Total Integration               | \$ 24,400,739         | \$ 28,209,608                      |
| Specialty Products and Services | 2,502,514             | 2,146,308                          |

|              |    |            |               |
|--------------|----|------------|---------------|
| Corporate    |    | 3,383,953  | 1,015,693     |
| Total Assets | \$ | 30,287,206 | \$ 31,371,609 |

**6. 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 effect on the Company's financial statements.

**7. Recently Issued Accounting Pronouncements**

**HENRY BROS. ELECTRONICS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS (UNAUDITED) □ (continued)**

The Company does not anticipate the adoption of recently issued accounting pronouncements to have a significant impact on the Company's results of operations, financial position or cash flows.



## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **OVERVIEW**

We are an established leader in the electronic physical security industry, specializing in integrated security systems and emergency preparedness.

### **OUR VISION AND STRATEGY**

Our vision is to maintain our leadership position in security technology. We intend to do this in part by:

Providing advice on product selection and system design;

Examining and thoroughly testing each security product as it would be set up for use in our customers' facilities; and,

Using only systems and components that are reliable and efficient to use.

In addition to growing the business organically, we have been actively pursuing the strategic acquisition of synergistic integrators and specialty products and service companies to further fuel steady growth. Consistent with our expansion strategy, we acquired seven companies since August of 2002.

To finance our acquisitions, we have used a combination of internally generated cash, company common stock and bank debt. We currently have a \$5 million credit facility with TD Banknorth, which includes a \$1 million term loan of which \$480,631 and \$377,795 was outstanding at March 31, 2007 and September 30, 2007, respectively. As part of our credit facility, we also have a \$4 million revolving credit facility. Borrowings under the revolving credit facility were \$3,085,897 and \$3,635,897 at March 31 and September 30, 2007, respectively. It is our expectation and intent to use cash and to incur additional debt as appropriate to finance future working capital and acquisitions. Additionally, to fund future acquisitions we would consider the issuance of subordinated debt, or the sale of equity securities, or the sale of existing Company assets.

### **TRENDS**

We anticipate our overall average operating margins for our business to be slightly negative for 2007, as compared to operating margins of (6.1)% and 5.0% for years 2006 and 2005, respectively.

There are several factors impacting operating margins, including levels of competition for a particular project and the size of the project. As a significant amount of our costs are relatively fixed, such as labor costs, increases or decreases in revenues can have a significant impact on operating margins. The Company continually monitors costs and pursues various cost control measures and sales initiatives to improve operating margins.

During the fourth quarter 2006, the Company began incurring costs related to the implementation of Sarbanes Oxley. While not significant in 2006, the spending will be significant in 2007 and 2008.

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 turn-key systems that integrate many different technologies. Systems are customized to meet the specific needs of its customers. Through the Specialty segment we provide emergency preparedness programs, and specialized radio frequency communication equipment and integration. Each of the Company’s segments markets nationwide with an emphasis in the Arizona, California, Colorado, Maryland, New Jersey, New York, Texas and Virginia. 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.

### **Three Months Ended March 31, 2007 compared to March 31, 2006**

**Revenue** - Revenue for the three months ended March 31, 2007 was \$10,871,301 representing an increase of \$1,726,473 or 18.9% as compared to \$9,144,828 for the three months ended March 31, 2006. CIS Security Systems Corp. (“CIS”) (Virginia and Maryland operations), acquired in October 2006, accounted for the increase in revenues. Revenues from CIS were \$1,932,559 for the three months ended March 31, 2007. Increased revenues from our California and Arizona operations were more than offset by a decline in our New Jersey operation.

Booked orders decreased 12% to approximately \$6,600,000 in the first quarter of 2007 as compared to approximately \$7,500,000 in the first quarter of 2006. The Company’s backlog as of March 31, 2007 was approximately \$23,500,000.

**Cost of Revenue** - Cost of revenue for the three months ended March 31, 2007 was \$8,715,125 as compared to \$6,206,653 for the three months ended March 31, 2006. The gross profit margin for the three months ended March 31, 2007 was 19.8% as compared to 32.1% for the three months ended March 31, 2006. The decline in the gross profit margin was driven principally from the New Jersey and California operations. The decline in New Jersey was the result of cost overruns on a number of installation projects. In addition, several of the larger jobs booked at the end of 2006 and early in 2007 were underway in the quarter ended March 31, 2007. These larger jobs typically have gross profit margins that are below the Company’s historical average. California’s decline was the result of cost overruns on a number of projects. In response to the decline in margins in our California Division, as discussed above, changes in management were implemented in the second quarter 2007 to more effectively manage the operations.

**Selling, General and Administrative Expenses** - Selling, general and administrative expense was \$3,264,167 for the three months ended March 31, 2007 as compared to \$2,628,754 for the three months ended March 31, 2006. This increase of 24.2% or \$635,413 was attributable to increased costs associated with the CIS acquisition in our 2006 fourth quarter, lower labor utilization, as well as higher corporate costs, due mainly to organizational changes and costs incurred in preparation for the Sarbanes Oxley implementation.

**Interest Income** Interest income for the three months ended March 31, 2007 was \$6,941 as compared to \$180 for the three months ended March 31, 2006.

**Interest Expense** - Interest expense for the three months ended March 31, 2007 was \$70,457 as compared to \$26,728 for the three months ended March 31, 2006. The average outstanding debt balance was significantly higher in the three month period ended March 31, 2006 versus that for the three months ended March 31, 2006. In addition, the prime rate of interest was higher in the 2006 period than that of the same period in the previous year.

**Tax Expense** - Due to the loss before tax for the three months ended March 31, 2007, the Company received a net tax benefit for that period. The tax benefit, however, was largely offset by state income taxes incurred by subsidiaries in those jurisdictions that were profitable during the period.

**Net Income** - As a result of the above noted factors our net loss was \$820,454 for the three months ended March 31, 2007 compared to net income of \$101,687 for the three months ended March 31, 2006. This resulted in diluted loss per share of \$(0.14) on weighted average diluted common shares outstanding of 5,749,964 for the three months ended March 31, 2007, as compared to diluted earnings per share of \$0.02 on weighted average diluted common shares outstanding of 5,904,177 for the three month period ended March 31, 2006.

**Liquidity and Capital Resources** - As of March 31, 2007, we had cash and cash equivalents of \$615,414. Our net working capital was \$9,374,912 at March 31, 2007 versus \$10,001,109 at December 31, 2006. Total debt at March 31, 2007 was \$4,206,042 compared to the December 31, 2006 balance of \$3,968,264.

Cash from operating activities provided \$318,418 during the three months ended March 31, 2007. The most significant source of cash resulted from a net decline in accounts receivable of \$2,086,183 and an increase in accounts payable of \$716,684. This was partially offset by a decrease in accrued expenses of \$1,702,751.

Cash used from investing activities was \$95,222 and was for the purchase of property and equipment.

Cash from financing activities provided \$192,364, of which \$238,000 represents borrowings against the revolving credit facility.

Borrowings under the revolving credit facility at September 30, 2007 were \$3,635,897. The Company is required to maintain certain financial and reporting covenants and restrictions on dividend payments under the terms of the Loan Agreement with TD Banknorth, N.A. The Company was not in compliance with certain of these bank covenants at March 31, 2007 and December 31, 2006. TD Banknorth, N.A. provided the Company with a waiver associated with the bank covenants in default in October 2007. As a condition of the waiver, the Company agreed to grant TD Banknorth a first security interest on its accounts receivable.

### **Critical Accounting Policies**

Disclosure of the Company's significant accounting policies is included in Note 1 to the consolidated financial statements of the Company's Annual Report on Form 10-K for year ended December 31, 2006. Some of these policies require management to make estimates and assumptions that may affect the reported amounts in the Company's financial statements.

## Forward Looking Statements

When used in this discussion, the words "believes", "anticipates", "contemplated", "expects", or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include changes in interest rates, the ability to control costs and expenses, significant variations in recognized revenue due to customer caused delays in installations, cancellations of contracts by our customers, and general economic conditions which could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

We have one revolving credit facility for which the interest rate on outstanding borrowings is variable and is based upon the prime rate of interest. At December 31, 2006, there was \$ 2,847,897 outstanding under this revolving credit facility and at March 31, 2007 and September 30, 2007, there was \$3,085,897 and \$3,635,897, respectively outstanding under this credit facility.

### Item 4. Controls and Procedures

#### (a) Evaluation of Disclosure Controls and Procedures

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 1934, as of the end of the period covered by this report. Based on this evaluation, the Chief Executive Officer, Chief Operating Officer and Chief Financial Officer concluded that, as of March 31, 2007, the design and operation of the Company's disclosure controls and procedures were not effective.

We learned that the Company did not maintain adequate policies and reconciliation procedures over the accounting for intercompany clearing and cash accounts and income taxes. As a result of these weaknesses, we performed extensive detail testing and reconciliation of past transactions in order to be able to determine the proper presentation of our financial information for past and current periods. This report contains restated financial results for the quarter ended March 31, 2006. These weaknesses in our internal disclosure controls and procedures were the cause of the delay in the filing of our 2006 Annual Report on Form 10-K and to the delay in the filing of this Quarterly Report on Form 10-Q.

While we are in the process of implementing a more efficient and reliable system of disclosure controls and procedures, we have, on an immediate basis, instituted interim compensating controls and procedures to ensure that information required to be disclosed in this Quarterly Report on Form 10-Q has been recorded, processed, summarized and reported to our senior management. The steps that we have taken to ensure that all material information about our company is accurately disclosed in this report include:

- the appointment of a new Chief Financial Officer in August 2006;

- the appointment of a new Chief Operating Officer ("COO") in August 2006. The COO then assumed the additional responsibilities of President in March 2007;
  - the appointment of a new Corporate Controller in April 2007;
  - the appointment of a new Controller for our California operations in April 2007;
  - the engagement of an outside public accounting firm to assist management in the preparation of our financial statement income tax provision in February 2007;
  - the engagement of temporary accounting personnel to assist in the closing and reconciliation processes
  - the performance of an extensive review of our financial statements for the year ended December 31, 2006 and quarter ended March 31, 2007.
  - implemented revised accounting procedures for recording and reconciling intercompany clearing and cash accounts and designed changes within the Company's financial reporting system to ensure all intercompany accounts eliminate in consolidation. These changes substantially do away with the use of spreadsheets as the tool to ensure that all intercompany accounts eliminate in consolidation, which are inherently more difficult to ensure compliance with the Company's internal control policies. Eliminating the use of spreadsheets also allows for fuller use of the Company's financial reporting system and the internal control safeguards built into the financial reporting software;
  - designed changes within the Company's financial reporting system to allow the financial reporting system to be the sole source of the consolidation of financial results of the Company. This change eliminated the use of spreadsheets, which was the method formerly used to consolidate the Company's financial results; and
  - implemented monthly financial and operational review procedures with each of our operating units.
- Nonetheless, a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues have been detected.

**(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, in order to correct the weaknesses described above and to improve our internal disclosure and control procedures on a going forward basis, we have continued to carry out the changes described in Item 4(a) above, and in addition we have hired additional qualified accounting personnel.

We intend to continue to evaluate our internal disclosure controls and procedures and implement improvements as required.

**Part II - Other Information**

**Item 1. Legal Proceedings**

Not applicable

**Item 1A. Risk Factors**

As of the quarter ended March 31, 2007 there were no material changes to the risk factors discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 6. Exhibits**

| <u>Number</u> | <u>Description</u>  |
|---------------|---|
| 31.1          | Rule 13a-14(a) 15d-14(a) Certification of Chief Executive Officer |
| 31.2          | Rule 13a-14(a) 15d-14(a) Certification of Chief Operating Officer |
| 31.3          | Rule 13a-14(a) 15d-14(a) Certification of Chief Financial Officer |
| 32            | Section 1350 Certification  |

In accordance with the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto authorized.

SIGNATURES

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

Henry Bros. Electronics, Inc.  
(Registrant)

Date: October 18, 2007

By: /s/ JAMES E. HENRY

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

Date: October 18, 2007

By: /s/ BRIAN REACH

Brian Reach  
President, Secretary, Chief Operating  
Officer and Director

Date: October 18, 2007

By: /s/ JOHN P. HOPKINS

John P. Hopkins  
Chief Financial Officer