HALIFAX CORP
Form 10-Q
February 14, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2005

OR

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

For the transition period from __________ to __________

Commission file Number 1-08964
Halifax Corporation
(Exact name of registrant as specified in its charter)

Virginia	54-0829246
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
5250 Cherokee Avenue, Alexandria, VA	22312
(Address of principal executive offices)	(Zip code)

(703) 750-2400
(Registrant s telephone number, including area code)
N/A

(Former name, former address and former fiscal year, if changed since last report)

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. þ Yes o 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. (Check one): Large Accelerated filer o accelerated filer o non-accelerated filer þ

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. There were 3,172,206 shares of common stock outstanding as of February 3, 2006.

HALIFAX CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

HALIFAX CORPORATION CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	December 31, 2005 (unaudited)	March 31, 2005
ASSETS		
CURRENT ASSETS		
Cash	$ 555	$ 1,264
Restricted cash	2,024	
Trade accounts receivable, net	11,147	12,468
Inventory, net	6,323	5,600
Prepaid expenses and other current assets	500	487
Deferred Tax Asset	1,083	3,814
TOTAL CURRENT ASSETS	21,632	23,633
PROPERTY AND EQUIPMENT	1,220	1,608
GOODWILL	2,918	6,129
INTANGIBLE ASSETS	1,388	1,309
OTHER ASSETS	133	141
DEFERRED TAX ASSET	750	930
TOTAL ASSETS	$ 28,041	$ 33,750
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 4,275	$ 5,955
Accrued expenses	3,467	4,776
Notes payable	168	662
Income taxes payable	609	
Deferred maintenance revenue	3,529	3,776
Current portion of long-term debt	4	17
TOTAL CURRENT LIABILITIES	12,052	15,186
LONG-TERM BANK DEBT	7,028	9,463
SUBORDINATED DEBT PAYABLE TO AFFILIATE	1,000	2,400
OTHER LONG-TERM DEBT		3
DEFERRED INCOME	233	278

TOTAL LIABILITIES		20,313		27,330
COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS EQUITY				
Preferred stock, no par value authorized 1,500,000, issued 0 shares				
Common stock, $.24 par value Authorized 6,000,000 shares Issued 3,428,890 as of December 31, 2005 and 3,177,096 as of March 31, 2005 Outstanding - 3,172,206 shares as of December 31, 2005 and 2,920,412 shares as of March 31, 2005		829		827
Additional paid-in capital		9,015		9,011
Accumulated (deficit)		(1,904)		(3,206)
Less Treasury stock at cost 256,684 shares		(212)		(212)
TOTAL STOCKHOLDERS EQUITY		7,728		6,420
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	28,041	$	33,750

See notes to Consolidated Financial Statements.

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HALIFAX CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED DECEMBER 31, 2005 AND 2004 (UNAUDITED)

	Three Months Ended December 31,		Nine Months Ended December 31,	
(Amounts in thousands, except share data)	2005	2004	2005	2004
Revenues	$ 13,390	$ 12,645	$ 42,027	$ 34,511
Costs	13,076	13,017	39,437	32,956
Gross margin	314	(372)	2,590	1,555
Selling and marketing	346	395	1,113	1,292
General and administrative	913	989	2,735	2,749
Abandonment of facilities				179
Severance costs	144		144	
Goodwill impairment Loss	3,211		3,211	
Operating loss	(4,300)	(1,756)	(4,613)	(2,665)
Other income			(5)	(3)
Interest expense	135	163	458	462
Loss before income taxes	(4,435)	(1,919)	(5,066)	(3,124)
Income tax benefit	(441)	(668)	(665)	(1,107)
Loss from continuing operations	(3,994)	(1,251)	(4,401)	(2,017)
Income from discontinued operations (net of taxes of $164 for nine months ended December 31, 2005 and $121 and $628 for the three and nine months ended December 31, 2004)		216	310	1,117
Gain on sale of discontinued operations (net of taxes of $3,900)	5,393		5,393	
Net income (loss)	$ 1,399	$ (1,035)	$ 1,302	$ (900)
Earnings (loss) per share basic				
Continuing operations	$ (1.26)	$ (.40)	$ (1.39)	$ (.67)
Discontinued operations		.07	.10	.37
Gain on sale of discontinued operations	1.70		1.70	
	$ .44	$ (.33)	$ .41	$ (.30)

Earnings (loss) per share diluted								
Continuing operations	$	(1.26)	$	(.40)	$	(1.39)	$	(.67)
Discontinued operations				.07		.10		.37
Gain on sale of discontinued operations		1.70				1.70		
	$	.44	$	(.33)	$	.41	$	(.30)
Weighted number of shares outstanding								
Basic		3,172,206		3,166,589		3,171,992		3,002,254
Diluted		3,183,370		3,238,316		3,187,613		3,052,128

No effect is given to dilutive securities for loss periods.

See notes to the Consolidated Financial Statements.

HALIFAX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED DECEMBER 31, 2005
(UNAUDITED

	Nine Months Ended December 31,	
(Amounts in thousands)	2005	2004
Cash flows from operating activities:		
Net loss continuing operations	$ (4,401)	$ (2,017)
Net income discontinued operations	5,703	1,117
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	809	797
Goodwill impairment	3,211	
Deferred tax benefit	(253)	(479)
Gain on sale of discontinued operations	(5,393)	
Changes in operating assets and liabilities:		
Accounts receivable	(922)	(1,621)
Inventory	(723)	167
Prepaid expenses and other assets	(254)	(195)
Accounts payable and accrued expenses	(4,204)	897
Income taxes payable	(106)	(10)
Deferred maintenance revenue	(247)	409
Deferred income	(45)	(44)
Total adjustments	(8,127)	(79)
Net cash (used in) provided by operating activities	(6,825)	(979)
Cash flows from investing activities:		
Acquisition of property and equipment	(248)	(599)
Proceeds from the sale of discontinued operations	13,057	
Restricted cash (related to sale of discontinued operations)	(2,024)	
Payment for purchase of acquired entities (net of cash received)	(330)	(802)
Net cash provided by (used in) investing activities	10,455	(1,401)
Cash flows from financing activities:		
Proceeds from bank borrowing	33,080	25,145
Retirement of bank debt	(35,515)	(23,148)
Retirement of other-long-term debt	(1,416)	(21)
Retirement of acquisition debt	(494)	
Proceeds from issuance of common stock	6	74

Net cash (used in) provided by financing activities	(4,339)	2,050
Net (decrease) in cash	(709)	(330)
Cash at beginning of period	1,264	430
Cash at end of period	$ 555	$ 100
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$ 268	$ 462
Cash paid for income taxes	$ 66	$ 80

See notes to the Consolidated Financial Statements.

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Halifax Corporation
Notes to Consolidated Financial Statements
(Unaudited)

Note 1 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and in accordance with the accounting principles generally accepted in the United States of America for interim financial information. Certain information and footnote disclosures normally included in the annual financial statements have been omitted pursuant to those rules and regulations.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all necessary adjustments and reclassifications (all of which are of a normal, recurring nature) that are necessary for fair presentation for the period presented. The results of the three and nine months ended December 31, 2005 are not necessarily indicative of the results to be expected for the full fiscal year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Halifax Corporation s (the Company) annual report on Form 10-K for the year ended March 31, 2005 filed with the Securities and Exchange Commission. Certain reclassifications have been made to the prior period financial statements to conform to the current presentation.

Note 2 Sale of Secure Network Services Business

On June 30, 2005, the Company simultaneously entered into and closed on an asset purchase agreement with INDUS Corporation pursuant to which it sold substantially all of the assets and certain liabilities of its secure network services business. The purchase price was approximately $12.5 million, in addition to adjustments for working capital of approximately of $608,000 for total consideration approximately $13.1 million. The asset purchase agreement provided that $3.0 million of the purchase price was to be held in escrow to serve as security to obtain certain consents, novations and indemnification obligations. At December 31, 2005, $2.0 million plus accrued interest of $24,000 remained in escrow, which is reflected on the accompanying balance sheet as restricted cash. On July 8, 2005, the $1.0 million held in escrow to serve as security to obtain certain consents was released to the Company. Certain novations and consents required under the asset purchase agreement were received and on January 26, 2006 $1.375 million plus accrued interest of $24,000 was paid and released to the Company. Accordingly, $625,000 of the original escrow amount remains in escrow as security for the payment of the Company s indemnification obligations pursuant to the asset purchase agreement, if any, and will be released to the Company eighteen (18) months following the date of the asset purchase agreement. (See Note 2 of the notes to Consolidated Financial Statements contained in the Company s Form 10-Q for the quarter ended September 30, 2005 for a discussion of the provisions relating to the novations and consents the Company was required to and did obtain.)

The asset purchase agreement contains representations, warranties, covenants and related indemnification provisions, in each case that are customary in connection with a transaction of this type; however, certain of the representations and warranties require updating to a date which is the earlier of the contract novation or thirty months from the closing. In addition, survival periods applicable to such updated warranties may be extended together with related indemnification periods. As of December 31, 2005, the Company is not aware of any claims, either asserted or unasserted associated with remaining amounts in escrow.

In connection with the asset purchase agreement, the Company also transferred to INDUS Corporation all of its right, title and interest in and to its Federal Supply Service Information Technology (Schedule 70) Contract (the Contract) with the federal government and a Blanket Purchase Agreement (BPA) that the Company entered into with one federal agency pursuant to the Contract. Since the Company has a need to utilize the Contract and BPA in connection with businesses that the Company has retained, it has entered into a transition services agreement with

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INDUS Corporation with respect to the Contract and BPA in order to continue performing existing, and to receive new, task/delivery orders from federal government agencies awarded under the Contract and BPA until such time as the Company is awarded a new Federal Supply Service Information Technology Contract.

The secure network services business comprised approximately $13.5 million, or 22%, and $9.5 million, or 19%, of our revenues for the fiscal years ended 2005 and 2004 and represented 7% of the Company s assets at March 31, 2005. As a result of receiving notification that the key contract had been novated, the Company recorded a gain on the sale of the secure network services business after taxes, fees and costs of approximately $5.4 million (net of income taxes of approximately $3.9 million). As a result of the sale of the secure network services business, the Company expects to utilize its net operating loss carryforward of approximately $3.0 million in fiscal year ending March 31, 2006 and has reduced its deferred tax asset accordingly. (See Note 6.)

Note 3 Acquisitions

On December 1, 2005, the Company acquired a contract from Technical Service and Support, Inc., (TSSI) for $330,000. The consideration consisted of cash at closing of $300,000 and an additional $30,000 in cash paid 30 days from the date of closing. In addition, the Company hired certain employees and subcontractors of TSSI as of December 1, 2005. The contract rights will be amortized over the remaining life of the contract of fifty-four months.

On September 30, 2004, the Company acquired 100% of the stock of AlphaNational Technology Services, Inc. (AlphaNational) for approximately $2.4 million. The consideration was cash of $200,000, notes payable of $168,000 and 235,249 shares of the Company s common stock valued at $4.38 per share, or $1.03 million plus liabilities assumed of $623,000. In addition, direct acquisition costs were approximately $379,000. The shares were discounted approximately 14% from the quoted market value of $5.10 because such shares were not registered under the Securities Act of 1933, as amended, and are subject to trading restrictions. In addition, the notes payable to the former AlphaNational shareholders were reduced from $500,000 to $168,000 based upon final adjustments to the closing balance sheet. In addition, the terms of the agreement provided for additional consideration of $150,000 to be paid if revenues of the acquired company exceeded certain targeted levels by September 30, 2005. The revenue targets were not achieved and, as a result, the additional consideration was not paid.

AlphaNational is an enterprise maintenance solutions company providing services to the national marketplace. The primary reasons for the acquisition of AlphaNational were to expand the Company s geographic base and strengthen its service delivery capability. AlphaNational also added a number of prestigious customers, added key management and enhanced the Company s ability to grow its partnership arrangements with the global service provider community. Other intangible assets of $810,000 will be amortized over their weighted-average useful lives and include customer contracts of $710,000 (five years) and non-compete agreements of $100,000 (two years).

Note 4 Accounts Receivable consisted of the following:

(amounts in thousands)	December 31, 2005	March 31, 2005
Amounts billed	$ 10,728	$ 12,373
Amounts unbilled	782	393
Allowance for doubtful accounts	(363)	(298)
Accounts receivable, net	$ 11,147	$ 12,468

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Note 5 Inventory

Inventory consists principally of spare parts, computers and computer peripherals, hardware and software. Inventory was recorded on the balance sheet net of allowances for inventory valuation reserve of $747,000 and $1.8 million at December 31, 2005 and March 31, 2005, respectively.

Note 6 Tax Matters

Deferred tax assets and liabilities on the balance sheets reflect the net tax effect of temporary differences between carrying amounts of assets and liabilities for financial statement purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are measured using enacted rates in effect for the year in which those temporary differences are expected to be recovered or settled. The deferred tax assets and liabilities are classified on the balance sheets as current or non-current based on the classification of the related assets and liabilities. Deferred tax assets are recognized for deductible temporary timing differences, along with net operating loss carryforwards and credit carryforwards, if it is more likely than not that the deferred tax benefits will be realized. To the extent a deferred tax asset cannot be recognized under the preceding criteria, a valuation allowance must be established. As a result of the sale of the secure network services business, the Company expects to utilize the net operating loss carryforward in its entirety. The net operating loss of approximately $3.0 million will be utilized for fiscal year ending March 31, 2006 to offset the taxable gain on the sale of the secure networks services business. Management has evaluated the remaining deferred tax asset giving consideration to the full utilization of the net operating loss carryforward and has concluded that, in its judgment, the deferred tax asset remains fully realizable and therefore a valuation allowance need not be established.

Note 7 Goodwill and Other Intangible Assets

Due to the sale of the Company s secure network services business as well as losses resulting form continuing operations, the Company tested its goodwill for impairment in advance of its annual testing date. The Company tested its goodwill impairment in accordance with Statement of Financial Accounting Standards Number 142, (SFAS No. 142) Goodwill and Other Intangible Assets . The resulting impairment loss was determined based on the applicable valuation methods, including the income and market approaches. The Company completed its test for impairment and recorded a $3.2 million non-cash charge for the impairment of goodwill. The charge is reflected as a component of operating loss in the accompanying consolidated statement of operations.

Note 8 Debt Obligations

Bank Debt

On June 29, 2005, the Company and its subsidiaries amended and restated the Amended and Restated Loan and Security Agreement with Provident Bank. The maturity date is June 30, 2007. The financial covenants are more fully described in Management s Discussion and Analysis of Financial Condition and Results of Operations- Liquidity and Capital Resources . The total amount available under the agreement is $12.0 million. The amount outstanding under the agreement bears interest at the bank s prime rate plus one-quarter percent (0.25%). The Company will also pay an unused commitment fee on the difference between the maximum amount it can borrow and the amount advanced, determined by the average daily amount outstanding during the period. The difference is multiplied by one-quarter percent (0.25%). The fee is paid on the last day of each quarter. Additionally, the Company pays a fee of $1,000 per month. Advances under the revolving credit agreement are collateralized by a first priority security interest on all of its assets as defined in the revolving credit agreement. As of December 31, 2005, $7.0 million was outstanding and $5.0 million was available to us. The interest rate at December 31, 2005 was 7.5%.

The revolving credit agreement contains representations, warranties and covenants that are customary in connection with a transaction of this type. The revolving credit agreement also contains certain financial covenants which the Company is required to maintain including, but not limited to, tangible net worth, current ratio, total liabilities to net worth ratio, debt service coverage and current ratio, as more fully described in the revolving credit agreement.

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At December 31, 2005, the Company was in compliance with the financial covenants contained in its revolving credit agreement.

For more information on the Company s amended and restated loan and security agreement see Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Notes Payable

In conjunction with the acquisition of AlphaNational, the Company issued notes to the former AlphaNational shareholders in the aggregate amount of $168,000, with an interest rate of 6%. The AlphaNational 6% notes mature on March 31, 2006.

Subordinated Debt Affiliates

The Arch C. Scurlock Children s Trust, (the Children s Trust) and Nancy M. Scurlock each own 392,211 shares of the Company s common stock or 25% in the aggregate of the Company s common stock. The Arch C. Scurlock Children s Trust and Nancy M. Scurlock are affiliates of the Company (Affiliates). Both are greater than 10% shareholders of the Company s common stock. Arch C. Scurlock, Jr., a beneficiary and trustee of the Children s Trust, and John H. Grover, a trustee of the Children s Trust, are our directors. The holders of the 8% promissory notes and 7% convertible subordinated debentures are the Children s Trust and Nancy M. Scurlock.

The Company 8% promissory notes and 7% convertible subordinated debentures are subordinated to the revolving credit agreement described above.

On June 29, 2005, the Company amended its 8% promissory notes and 7% convertible subordinated debentures to extend the maturity date to July 1, 2007, which date is the next day immediately succeeding the expiration of the second amended and restated loan and security agreement.

During the quarter ended September 30, 2005 and with the consent of Provident Bank, the Company agreed to make principal and accrued interest payments on the 8% promissory notes and 7% convertible subordinated debentures aggregating $1.5 million. The Company utilized a portion of the proceeds from the sale of its secure network services business to make these payments to the holders of its 8% promissory notes and 7% convertible subordinated debentures and made such payments on July 13, 2005. After such payment, the principal balance on the 7% convertible subordinated debenture was paid in full and the aggregate principal balance of the 8% promissory notes was $1.0 million.

The Company s revolving credit agreement requires the lender s approval for the payment of dividends or distributions as well as the payment of principal or interest on the Company s outstanding subordinated debt, which is owned by the Affiliates. Interest expense on the subordinated debt owned by Affiliates is accrued on a current basis.

The balance of accrued but unpaid interest due on the notes to the Affiliates was approximately $127,000 at December 31, 2005.

Note 9 Stock Based Compensation

The Company recognizes expense for stock-based compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Accordingly, compensation cost is recognized for the excess of the estimated fair value of the stock at the grant date over the exercise price, if any.

In accordance with SFAS No. 148, Accounting for Stock-Based Compensation- Transition and Disclosure (SFAS No. 148), the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standard (SFAS No. 123) Share-based Payment to stock-based employee compensation is as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
(Amounts in thousand, except share data)	2005	2004	2005	2004
Net Income (loss) as reported	$ 1,399	$ (1,035)	$ 1,302	$ (900)
Add: Compensation expense under APB No 25				
Deduct: Stock-based compensation expense under the fair value method, net of tax	20	28	60	83
Pro-forma net loss	$ 1,379	$ (1063)	$ 1,242	$ (983)
Earnings (loss) per common share (as reported):				
Basic	$ .44	$ (.33)	$ 41	$ (.30)
Diluted	$ .44	$ (.33)	$ .41	$ (.30)
Pro-forma earnings (loss) per common share:				
Basic	$ .43	$ (.34)	$ .39	$ (.33)
Diluted	$ .43	$ (.34)	$ .39	$ (.33)

These pro-forma amounts are not necessarily indicative of future effects of applying the fair value-based method due to, among other things, the vesting period of the stock options and the fair value of additional stock options issued in future years.

Note 10 Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Errors Corrections- a replacement of APB Opinion No. 20 and FASB Statement No. 3, (SFAS No. 154) . SFAS No. 154 changes the requirement for the accounting and reporting of a change in an accounting principle. SFAS No. 154 is effective for accounting changes and correction of errors in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of this statement to have a material impact on its financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R. SFAS No. 123R addresses the requirements of an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost of such awards will be recognized over the period during which an employee is required to provide services in exchange for the award. The Company will be required to adopt SFAS 123R during the first quarter of fiscal year 2007. The Company is currently evaluating the impact that this pronouncement will have on its financial statements.

Note 11 Contingencies

On August 17, 2005, the Company was named as a defendant in a lawsuit alleging that the Company breached its contract with a subcontractor, did not act in good faith, and further did not comply with the terms and conditions of the agreement. The plaintiff sought compensatory damages of approximately $1.6 million and punitive damages of $350,000 as well certain prejudgment and post judgment interest. If the plaintiff prevails, the Company s results of operations, cash flows or financial position would be materially affected.

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On January 27, 2006, the Company was granted a motion for summary judgment and the lawsuit was dismissed. Subsequently, the plaintiff filed an appeal of the ruling. Based on all of the currently available information, and discussions with legal counsel representing the Company in connection with the matter, Company management has determined that a reserve for potential loss is not necessary at this time.

As a result of continued losses on a large long-term nation-wide enterprise maintenance contract, the Company incurred an operating loss for the three and nine months ended December 31, 2005. The Company has recorded a contract loss reserve of $450,000 for estimated future losses on this contract. The Company has undertaken steps to bring final resolution to certain contract issues related to a large nation-wide enterprise maintenance contract. The loss reserve represents estimated costs to be incurred through March 31, 2006 and assumes anticipated cessation of the contract effective March 31, 2006. While the ultimate amount of additional costs to be incurred are dependent upon future developments, in management s opinion, the reserve for contract loss is adequate to cover the future loss on the contract.

In addition, during the quarter ended December 31, 2005, the Company recorded severance costs for contracts of approximately $144,000 for employees working on several contracts that expired during the quarter ended December 31, 2005. Not withstanding the foregoing, it is reasonably possible that the reserve for contract loss and severance costs incurred may not be adequate to cover future losses on these contracts. Adjustments, if any, to estimates recorded resulting from additional costs incurred will be reflected in operations in the periods in which such adjustments are known.

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

Forward-Looking Statements

Certain statements in this document constitute forward-looking statements within the meaning of the Federal Private Securities Litigation Reform Act of 1995. While forward-looking statements sometimes are presented with numerical specificity, they are based on various assumptions made by management regarding future circumstances over many of which Halifax Corporation (Halifax, we, our or us) have little or no control. Forward-looking statements may be identified by words including anticipate, believe, estimate, expect and similar expressions. We caution readers that forward-looking statements, including without limitation, those relating to future business prospects, revenues, anticipated cessation of a long-term enterprise maintenance contract, estimated loss reserve, working capital, liquidity, and income, are subject to certain risks and uncertainties that would cause actual results to differ materially from those indicated in the forward-looking statements. Factors that could cause actual results to differ from forward-looking statements include the concentration of our revenues, risks involved in contracting with our customers, including the difficulty to accurately estimate costs when bidding on a contract and the occurrence of start-up costs prior to receiving revenues and contracts with fixed priced provisions, government contracting risks, potential conflicts of interest, difficulties we may have in attracting and retaining management, professional and administrative staff, fluctuation in quarterly results, risks related to acquisitions and our acquisition strategy, continued favorable banking relationships, the availability of capital to finance operations and planned growth and ability to make payments on outstanding indebtedness, weakened economic conditions, reduced end-user purchases relative to expectations, pricing pressures, excess and obsolete inventory, acts of terrorism, energy prices, continued losses, risks related to competition and our ability to continue to perform efficiently on contracts, and other risks and factors identified from time to time in the reports we file with the Securities and Exchange Commission (SEC). Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected.

Forward-looking statements are intended to apply only at the time they are made. Moreover, whether or not stated in connection with a forward-looking statement, we undertake no obligation to correct or update a forward-looking statement should we later become aware that it is not likely to be achieved. If we were to update or correct a forward-looking statement, investors and others should not conclude that we will make additional updates or corrections thereafter.

Overview

We are a nationwide high availability, multi-vendor, enterprise maintenance service provider for enterprises, including businesses, global service providers, governmental agencies and other organizations. We have undertaken significant changes to our business in recent years. After selling the operational outsourcing division in 2001, we began the shift of our business to a predominantly services model. In September 2004, we completed the acquisition of AlphaNational Technology Services, Inc., in August 2003, we completed the acquisition of Microserv, Inc., and most recently, in December 2005, we acquired a contract from Technical Service and Support, Inc. (TSSI). These acquisitions significantly expanded our geographic base, strengthened our nationwide service delivery capabilities, bolstered management depth, and added several prestigious customers. In June 2005, we sold substantially all of the assets and certain liabilities of our secure network services business. We are continuing to focus on our core high availability maintenance services business while at the same time evaluating our future strategic direction.

We offer a growing list of services to businesses, global service providers, governmental agencies, and other organizations. Our services are customized to meet each customer s needs providing 7x24x365 service, personnel with required security clearances for certain governmental programs, project management services, depot repair and roll out services. We believe the flexible services we offer to our customers enable us to tailor a solution to obtain maximum efficiencies within their budgeting constraints.

When we are awarded a contract to provide services, we may incur expenses before we receive any contract payments. This may result in a cash short fall that may impact our working capital and financing. This may also cause fluctuations in operating results as start-up costs are expensed as incurred.

Our goal is to return to and maintain profitable operations, expand our customer base of clients through our existing global service provider partners, seek new global service provider partners, and enhance the technology we utilize to deliver cost-effective services to our customers. Our ability to increase profitability will be impacted by our ability to continue to compete within the industry, and our ability to replace contracts which were sold in connection with the sale of the secure network services business with new high availability maintenance contracts. We must also effectively manage expenses in relation to revenues by directing new business development towards markets that complement or improve our existing service lines. We must continue to emphasize operating efficiencies through cost containment strategies, re-engineering efforts and improved service delivery techniques, particularly within costs of services, selling, marketing and general and administrative expenses.

Our future operating results may be affected by a number of factors including uncertainties relative to national economic conditions and terrorism, especially as they affect interest rates, increased energy costs, the reduction in revenue as a result of the sale of our secure network services business, industry factors and our ability to successfully increase our sales of services, accurately estimate costs when bidding on a contract, and effectively manage expenses. We have streamlined our service delivery process, expanded our depot repair facility to repair rather than purchase new component parts and are working with our customers to modify the processes under which services are rendered to our customers.

In conjunction with the sale of our secure network services business, we have undertaken various cost containment initiatives including staff reductions and elimination of services in order to align our expenses in relation to our revenues. Many of the cost containment strategies have been implemented during the quarter ended December 31, 2005 and will continue over the next several quarters.

The industry in which we operate has experienced unfavorable economic conditions, and competitive challenges. We continue to lose money on a large nation-wide enterprise maintenance contract in spite of our efforts to stream line our service delivery operations. Our fiscal year 2006 operating results reflect the impact of this contract and challenging environment. We continue to see significant price competition and customer demand for higher service attainment levels. In addition, there is significant price competition in the market for state and local government contracts as a result of budget issues, political pressure and other factors beyond our control. As experienced with the losses of some of our contracts, high quality and longevity of service may have little influence in the customer decision making process.

On June 30, 2005, we simultaneously entered into and closed on an asset purchase agreement with INDUS the company pursuant to which it sold substantially all of the assets and certain liabilities of its secure network services business. The purchase price was approximately $12.5 million, in addition to adjustments for working capital of approximately of $608,000 for total consideration approximately $13.1 million. The asset purchase agreement provided that $3.0 million of the purchase price was to be held in escrow as security to obtain certain consents, novations, and indemnification obligations. On July 8, 2005, the $1.0 million held in escrow to serve as security to obtain certain consents was released to us. Certain novations and consents required under the asset purchase agreement were received and on January 26, 2006, and $1.375 million plus accrued interest of $24,000 was released to us. Accordingly, $625,000 of the original escrow amount remains in escrow as security for the payment of the Company s indemnification obligations pursuant to the asset purchase agreement, if any, and will be released to the Company eighteen (18) months following the date of the asset purchase agreement. At December 31, 2005, $2.0 million plus accrued interest of $24,000 remained in escrow, which is reflected on the accompanying balance sheet as restricted cash. (See Note 2 of the notes to Consolidated Financial Statements contained in the Company s Form 10-Q for the quarter ended September 30, 2005 for a discussion of the provisions related to the novations and consents the Company was required to and did obtain.)

The asset purchase agreement contains representations, warranties, covenants and related indemnification provisions, in each case that are customary in connection with a transaction of this type; however, certain of the representations and warranties require updating to a date which is the earlier of the contract novation or thirty months from the closing. In addition, survival periods applicable to such updated warranties may be extended together with related indemnification periods. As of December 31, 2005, we are not aware of any claims, either asserted or unasserted associated with the remaining amounts in escrow.

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In connection with the asset purchase agreement, we also transferred to INDUS Corporation all of its right, title and interest in and to its Federal Supply Service Information Technology (Schedule 70) Contract (the Contract) with the federal government and a Blanket Purchase Agreement (BPA) that we entered into with one federal agency pursuant to the Contract. Since we have a need to utilize the Contract and BPA in connection with businesses that we have retained, we have entered into a transition services agreement with INDUS Corporation with respect to the Contract and BPA in order to continue performing existing, and to receive new, task/delivery orders from federal government agencies awarded under the Contract and BPA until such time as we are awarded a new Federal Supply Service Information Technology Contract.

The secure network services business comprised approximately $13.5 million, or 22%, and $9.5 million, or 19%, of our revenues for the fiscal years ended 2005 and 2004 and represented 7% of our assets at March 31, 2005.

During the quarter ended December 31, 2005, upon the receipt of the novation of the key contract, we recorded a gain on the sale of the secure network services business after taxes, fees and costs of approximately $5.4 million (net of income taxes of approximately $3.9 million). As a result of the sale of the secure network services business, we expect to utilize our net operating loss carryforward of approximately $3.0 million in fiscal year ending March 31, 2006, and have reduced our deferred tax asset accordingly. (See Note 6 to our notes to Consolidated Financial Statements.)

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Results of Operations

The following discussion and analysis provides information management believes is relevant to an assessment and understanding of our consolidated results of operations for the three and nine months ended December 31, 2005 and 2004, respectively, and should be read in conjunction with the consolidated financial statements and notes thereto.

(Amounts in thousand, except share data and percents)

	Three Months Ended December 31,				Nine Months Ended December 31,			
Results of Operations	2005	2004	Change	%	2005	2004	Change	%
Revenues	$ 13,390	$ 12,645	$ 745	6%	$ 42,027	$ 34,511	$ 7,516	22%
Costs	13,076	13,017	59		39,437	32,956	6,481	20%
Percent of revenues	98%	103%			94%	95%		
Gross margin	314	(372)	686	184%	2,590	1,555	1,035	67%
Percent of revenues	2%	(3%)			6%	5%		
Selling and marketing	346	396	(50)	(13%)	1,113	1,292	(179)	(14%)
Percent of revenues	3%	3%			3%	4%		
General & administrative	913	989	(76)	(8%)	2,735	2,749	(14)	( )
Percent of revenues	7%	8%			7%	8%		
Abandonment of facility						179	179	100%
Severance costs	144		144	100%	144		144	100%
Goodwill impairment	3,211		3,211	100%	3,211		3,211	100%
Operating loss	(4,300)	(1,756)	(2,544)	(145%)	(4,613)	(2,665)	(1,958)	(74%)
Percent of revenues	(32)%	(14)%			(11)%	(8)%		
Other income					(5)	(3)	(2)	67%
Interest expense	135	163	(28)	(17%)	458	462	(4)	(1%)
Loss before income tax	(4,435)	(1,919)	(2,516)	(131)%	(5,066)	(3,124)	(1,942)	(62%)
Income tax benefit	(441)	(668)	(227)	(34%)	(665)	(1,107)	442	(40%)
Loss from continuing operations	(3,994)	(1,251)	(2,743)	(219%)	(4,401)	(2,017)	(2,384)	(118%)
Income from discontinued operations (net of		216	(216)	(100%)	310	1,117	(807)	(72%)

taxes)												
Gain from discontinued operation		5,393				5,393	100%		5,393			5,393	100%
Net income (loss)	$	1,399	$	(1,035)	$	2,434	235%	$	1,302	$	(900)	$ 2,202	245%
Earnings (loss) per share basic:												
Continuing operations	$	(1.26)	$	(.40)				$	(1.39)	$	(.67)		
Discontinued operations				.07					.10		.37		
Gain on sale of discontinued operations		1.70							1.70				
	$	.44	$	(.33)				$	.41	$	(.30)		
Earnings (loss) per share diluted:												
Continued operations	$	(1.26)	$	(.40)				$	(1.39)	$	(.67)		
Discontinued operations				.07					.10		.37		
Gain on sale of discontinued operations		1.70							1.70				
	$	.44	$	(.33)				$	.41	$	(.30)		
Weighted average number of common shares outstanding													
Basic		3,172,206		3,166,589					3,171,992		3,002,254		
Diluted		3,183,370		3,238,316					3,187,613		3,052,128		

No effect is given to dilutive securities for loss periods.

Revenues

Revenues are generated from the sale of high availability enterprise maintenance services and technology deployment (consisting of professional services, seat management and deployment services, and product sales). Services revenues include monthly recurring fixed unit-price contracts as well as time-and-material contracts. Amounts billed in advance of the services period are recorded as unearned revenues and recognized when earned. The revenues and related expenses associated with product held for resale are recognized when the products are delivered and accepted by the customer.

The composition of revenues for:

(Dollar amounts in thousands)	Three Months Ended December 31, 2005	2004	Change	%	Nine Months Ended December 31, 2005	2004	Change	%
Services	$ 12,559	$ 11,984	$ 575	5%	$ 38,948	$ 32,049	$ 6,899	22%
Product held for resale	831	661	170	26%	3,079	2,462	617	25%
Total Revenue	$ 13,390	$ 12,645	$ 745	6%	$ 42,027	$ 34,511	$ 7,516	22%

Revenues for the three months ended December 31, 2005 increased 6%, or $745,000, to $13.4 million from $12.6 million for the three months ended December 31, 2004. For the nine months ended December 31, 2005, revenues increased 22%, or $7.5 million, from $34.5 million to $42.0 million. Revenues from services for the three months ended December 31, 2005 increased 5%, or $575,000, to $12.6 million from $11.9 million for the three months ended December 31, 2004. For the nine months ended December 31, 2005, revenues increased 22%, or $6.9 million, to $38.9 million from $32.0 million for the comparable period ended December 31, 2004. The reasons for the increase in services revenue for both the three and nine month periods ending December 31, 2005 was the improved revenue stream from several long-term enterprise maintenance contracts, increased time and material invoicing and the inclusion of the revenues of approximately $340,000 from a contract purchased on November 30, 2005.

For the three months ended December 31, 2005, product held for resale increased $170,000, or 26%, from $661,000 for the three months ended December 31, 2004 to $831,000. Product held for resale increased 25%, or $617,000, for the nine months ended December 31, 2005, from $2.4 million for the nine months ended December 31, 2004 to $3.1 million. The increase in product held for resale was a result of several large one time orders. We have de-emphasized product sales and intend to focus primarily on our recurring services revenue model for enterprise maintenance solutions. As a result, we do not expect to see any material increases in product sales in future periods.

Costs

Included within costs are direct costs, including fringe benefits, product and part costs, and other costs.

A large part of our service costs are support costs and expenses that include direct labor and infrastructure costs to support our service offerings. As we continue to expand our service offerings, we anticipate that the direct costs to support these service offerings will continue to increase in relation to the growth in revenues, however, our overall costs as a percent of revenue are expected to decrease as cost containment efforts take effect. As a result of continued losses on a large long-term nation-wide enterprise maintenance contract, we incurred an operating loss for the three and nine months ended December 31, 2005. We have recorded a contract loss reserve of $450,000 for estimated future losses on this contract. We have undertaken steps to bring final resolution to certain contract issues related to a large nation-wide enterprise maintenance contract. The loss reserve represents estimated costs to be incurred through March 31, 2006 and assumes anticipated cessation of the contract effective March 31, 2006. While the ultimate amount of additional costs to be incurred are dependent upon future developments, in management s opinion, the reserve for contract loss is adequate to cover the future loss on the contract.

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In addition, during the quarter ended December 31, 2005, the we recorded severance costs for contracts of approximately $144,000 for employees working on several contracts that expired during the quarter ended December 31, 2005. Not withstanding the foregoing, it is reasonably possible that the reserve for contract loss and severance costs incurred may not be adequate to cover future losses on these contracts. Adjustments, if any, to estimates recorded resulting from additional costs incurred will be reflected in operations in the periods in which such adjustments are known.

On long-term fixed unit-price contracts, part costs vary depending upon the call volume received from customers during the period. Many of these costs are volume driven and as volumes increase, these costs as a percentage of revenues increase, generating a negative impact on profit margins. We have also been negatively impacted from high costs associated with a large nation-wide enterprise maintenance contract where the cost to deliver services has been driven by high than expected failure rates and labor costs and as a result of which we recorded a reserve for contract loss of $450,000 for the quarter ended December 31, 2005.

The variable components of costs associated with fixed price contracts are part costs, overtime, subcontracted labor, mileage reimbursed, and freight. Part costs are highly variable and dependent on several factors, based on the types of equipment serviced, equipment age and usage, and environment. On long-term fixed unit-price contracts, parts and peripherals are consumed on service calls.

For installation services and seat management services, product may consist of hardware, software, cabling and other materials that are components of the service performed. Product held for resale consists of hardware and software. Costs were comprised of the following components:

(Dollar amounts in	Three Months Ended December 31,				Nine Months Ended December 31,			
thousands)	2005	2004	Change	%	2005	2004	Change	%
Direct costs	$ 11,678	$ 11,632	$ 46	%	$ 35,576	$ 29,745	$ 5,831	20%
Indirect costs	1,398	1,385	13	1%	3,861	3,211	650	20%
Total costs	$ 13,076	$ 13,017	$ 59	%	$ 39,437	$ 32,956	$ 6,481	20%

Total costs for the three months ended December 31, 2005 and 2004 remained unchanged at $13.0 million. For the nine months ended December 31, 2005, total costs increased $6.4, million or 20%, to $39.4 million compared to $32.9 million for the comparable period in 2004. The increase in costs resulted from increased costs incurred to support the increase in revenue discussed above and much higher than expected costs related to supporting a large nation-wide enterprise maintenance contract. Included in direct costs was a charge for additional costs of $450,000 and $300,000, respectively, for the three and nine month periods ended December 31, 2005 and 2004 for additional contract losses related to a large nation-wide enterprise maintenance contract through March 31, 2006 and 2005, respectively. See Note 11 of the notes to Consolidated Financial Statements.

Direct costs include the direct labor for technical services, parts and products, and other associated costs in providing our service offerings to our customers. For the three months ended December 31, 2005 and 2004, direct costs were $11.6 million. For the nine month period ending on December 31, 2005, direct costs increased 20%, or $5.8 million, to $35.6 million from $29.7 million for the same period in 2004.

Indirect costs include costs related to operating our call center, logistics dispatch operations, facility costs and other costs incurred to support the field service technicians and engineers. Indirect costs increased $13,000 for the three months ended December 31, 2005 over the same period in 2004 remaining at 1.4 million. Indirect costs increased 20%, or $650,000, from $3.2 million for the nine months ended December 31, 2004 to $3.9 million for the nine months ended December 31, 2005. The increase in indirect costs was due to additional personnel costs to support the field force.

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As discussed above, many of the cost containment strategies have been implemented during the quarter ended December 31, 2005 have had some positive affect the result for the three months ended December 31, 2005. However, in spite of these efforts, we continued to absorb high costs associated with a large nation-wide enterprise maintenance contract, which has resulted in the increase in total costs for the nine months ended December 31, 2005. In addition, we have recorded a contract loss reserve of $450,000 for estimated future losses on this contract. We have undertaken steps to bring final resolution to certain contract issues related to a large nationwide enterprise maintenance contract this quarter. The loss reserve represents estimated costs to be incurred through March 31, 2006 and assumes anticipated cessation of the contract effective March 31, 2006. While the ultimate amount of additional costs to be incurred are dependent upon future developments, in management s opinion, the reserve for contract loss is adequate to cover the future loss on the contract. Not withstanding the foregoing, it is reasonably possible that the reserve for contract loss may not be adequate to cover future losses on this contract. Adjustments, if any, to estimates recorded resulting from additional costs incurred will be reflected in operations in the periods in which such adjustments are known.

Gross Margin

As a percentage of revenues, gross margin was 2% and 6% for the three and nine months ended December 31, 2005, respectively, and (3%) and 5% for the three and nine months ended December 31, 2004, respectively. Although we have demonstrated a modest improvement in our gross margins, when compared to last year, our gross margins were negatively impacted by the continued losses incurred on a large nation-wide enterprise maintenance contract and the additional loss accrual on this contract as discussed above .

Selling and Marketing Expense

Selling and marketing expense consists primarily of salaries, commissions, travel costs and related expenses.

Selling and marketing expense was $346,000 for the three months ended December 31, 2005 compared to $396,000 for the three months ended December 31, 2004, a decrease of $50,000, or 13%. For the nine months ended December 31, 2005 compared to the nine months ended December 31, 2004 selling and marketing expense was $1.1 million compared to $1.3 million, a 14% decrease. The decrease in selling and marketing expense was the result of a reduction in personnel costs and reduced marketing efforts.

General and Administrative

Our general and administrative expenses consist primarily of non-allocated overhead costs. These costs include executive salaries, accounting, contract administration, professional services such as legal and audit, business insurance, occupancy and other costs.

For the three months ended December 31, 2005, general and administrative expense decreased when compared to the three months ended December 31, 2004 from $989,000 to $913,000. For the nine months ended December 31, 2005, general and administrative expenses remained unchanged at $2.7 million when compared to the nine months ended December 31, 2004.

Goodwill Impairment

Due to the sale of our secure network services business as well as losses resulting form continuing operations, we tested its goodwill for impairment in advance of its annual testing date. We tested its goodwill impairment in accordance with Statement of Financial Accounting Standards Number 142, (SFAS No. 142) Goodwill and Other Intangible Assets . The resulting impairment loss was determined based on the applicable valuation methods, including the income and market approaches. We completed our test for impairment and recorded a $3.2 million non-cash charge for the impairment of goodwill. The charge is reflected as a component of operating loss in the accompanying consolidated statement of operations.

Severance Costs and Abandonment of Facilities

During the quarter ended December 31, 2005, we recorded severance costs for employees working on several contacts that expired of approximately $144,000.

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After a review of our facility requirements in September 2004, we determined that as a result of several acquisitions we had excess space. For the nine month period ended December 31, 2004, we recorded a charge of $179,000 for the abandonment of a facility related to the sub-leasing of certain office space.

Operating Loss

With the sale of our secure network services business, the financial performance of that business was recorded as discontinued operations and, as a result, for the three months ended December 31, 2005, we incurred an operating loss of $4.3 million compared to operating loss of $1.8 million for the three months ended December 31, 2004 and a operating loss for the nine months ended December 31, 2005 of $4.6 million compared to $2.7 million for the comparable period last year.

The operating loss was the result of on-going losses in connection with the performance of a large nation-wide enterprise maintenance contract, severance costs, and an impairment charge for goodwill.

Interest Expense

Interest expense for the three months ended December 31, 2005 was $135,000 compared to $163,000 for the same period in 2004. The decrease in interest expense was related to the reductions in long term debt with the use of proceeds from the sale of the secure network services business. For the nine months ended December 31, 2005 compared to the nine months ended December 31, 2004, interest expense was $458,000 compared to $462,000. The decrease for the nine month period was the result of lower borrowings in the second half of the year compared to the prior year offset by increases in the interest rate charged to us on our bank debt due to increases in the bank s prime interest rate.

Income Tax Benefit

Due to the loss from continuing operations, for the three months ended December 31, 2005, we recorded an income tax benefit of $441,000 compared to an income tax benefit of $668,000 for the comparable period in 2004. For the nine months ended December 31, 2005, we recorded an income tax benefit of $665,000 compared to an income tax benefit of $1.1 million for the nine months ended December 31, 2004.

Income from discontinued operations

Income from discontinued operations was $0 compared to $216,000, net of income taxes of $121,000, for the three months ended December 31, 2005 compared to December 31, 2004. For the nine months ended December 31, 2005, income from discontinued operations was $310,000, net of income taxes of $164,000 compared to $1.1 million, net of income taxes of $628,000 for the same period a year ago.

Gain on sale of discontinued operations

As a requirement of the sale of our secure network services business, we deferred the recognition of the gain on the sale until certain contract contingencies related to the novation of the Key contract were obtained. On January 26, 2006, the final novations were received and the contingencies resolved. As a result of the foregoing, we have recorded a gain on the sale of discontinued operation of approximately $5.4 million for the three and nine month period ended December 31, 2005.

Net Income (loss)

For the three months ended December 31, 2005, the net income was $1.4 million, compared to a net loss of $1.0 million for the comparable period in 2004. The primary reason for the increase in net income was the result from the gain on the sale of our secure network services business which was partially off set by the loss from continuing operations, severance costs, and a charge for the impairment of goodwill.

For the nine months ended December 31, 2005, we recorded net income of $1.3 million compared to a net loss of $900,000 for the nine months ended December 31, 2004 for the same reasons described above.

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Liquidity and Capital Resources

As of December 31, 2005, we had approximately $2.5 million of cash on hand. Sources of our cash for the three and nine months ended December 31, 2005 have been from the sale of our secure network services business and our revolving credit facility, as described below.

We anticipate that our primary sources of liquidity in fourth fiscal quarter of 2006 will be, cash on hand generated from the sale of the secure network services business in June 2005, and cash available to us under our revolving credit agreement.

Cash generated from operations may be affected by a number of factors. See Forward Looking Statements and Business Risk Factors in our Form 10-K for the year ended March 31, 2005 for a discussion of the factors that can negatively impact the amount of cash we generate from our operations.

Although we have no definite plans to undertake any future debt or equity financing, we will pursue all potential funding alternatives in the event we need additional capital. Among the possibilities for raising additional funds are issuances of debt or equity securities, and other borrowings under secured or unsecured loan arrangements. There can be no assurances that additional funds will be available to us on acceptable terms or in a timely manner.

Our future financial performance will depend on our ability to continue to reduce and manage operating expenses, as well as our ability to grow revenues through obtaining new contracts and replacing the revenue from contracts sold in connection with the sale of the secure networks services business. Our revenues will continue to be impacted by the loss of customers due to price competition and technological advances. Our financial performance will also depend on our ability to terminate or re-negotiate the large nation-wide enterprise maintenance contract for which we recorded a reserve for contract loss of $450,000 during the quarter ended December 31, 2005. See Note 11 of the notes to the Consolidated Financial Statements. Our future financial performance could be negatively affected by unforeseen factors and unplanned expenses. See Forward Looking Statements and Business Risk Factors in our Form 10-K for the year ended March 31, 2005.

In furtherance of our business strategy, transactions we may enter into could increase or decrease our liquidity at any point in time. If we were to obtain a significant contract or make contract modifications, we may be required to expend our cash or incur debt, which will decrease our liquidity. Conversely, if we dispose of assets, we may receive proceeds from such sales which could increase our liquidity. From time to time, we are in discussions concerning acquisitions and dispositions which, if consummated, could impact our liquidity, perhaps significantly.

We expect to continue to require funds to meet remaining interest and principal payment obligations, capital expenditures and other non-operating expenses. Our future capital requirements will depend on many factors, including revenue growth, expansion of our service offerings and business strategy. We believe that our available funds, together with our existing revolving credit facility, will be adequate to satisfy our current and planned operations for at least the next 12 months.

At December 31, 2005, we had working capital of $9.6 million compared to working capital of $8.4 million at March 31, 2005. The current ratio was 1.80 at December 31, 2005 compared to 1.56 at March 31, 2005. The increase in working capital was primarily attributable to using the proceeds from the sale of our secure network services business described elsewhere to reduce debt.

On June 30, 2005, we sold our secure network services business for $12.5 million. The gain on the sale of the business was $5.4 million net of taxes and fees. The proceeds were used to reduce debt and provide working capital. Capital expenditures for the nine months ended December 31, 2005 were $248,000 as compared to $599,000 for the same period 2004. We anticipate fiscal year 2006 technology requirements to result in capital expenditures totaling approximately $700,000. We continue to sublease a portion of our headquarters building which reduces our rent expense by approximately $400,000 annually.

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On June 29, 2005, we and our subsidiaries amended and restated our Amended and Restated Loan and Security Agreement, referred to as the revolving credit agreement with Provident Bank. The maturity date is June 30, 2007. The amount available under the revolving credit agreement remains at $12.0 million. The amount outstanding under the revolving credit agreement bears interest at the bank s prime rate plus one-quarter percent (0.25%). The fee is paid on the last day of each quarter. We will also pay an unused commitment fee on the difference between the maximum amount we can borrow and the amount advanced, determined by the average daily amount outstanding during the period. The difference is multiplied by one-quarter percent (0.25%). Additionally, we pay a fee of $1,000 per month. Advances under the revolving credit agreement are collateralized by a first priority security interest on all of our assets as defined in the revolving credit agreement. As of December 31, 2005, $7.0 million was outstanding and $5.0 million was available to us. The interest rate at December 31, 2005 was 7.5%.

The revolving credit agreement contains representations, warranties and covenants that are that are customary in connection with a transaction of this type. The revolving credit agreement contains certain covenants including, but not limited to: (i) maintaining the Company s accounts in a cash collateral accounts at Provident Bank, the funds in which accounts we may apply in our discretion, against our obligations owed to Provident Bank, (ii) notifying Provident Bank in writing of any cancellation of a contract having annual revenues in excess of $250,000, (iii) in the event receivables arise out of government contracts, we will assign to Provident Bank all government contracts with amounts payable of $100,000 or greater and in duration of six months or longer, (iv) obtaining written consent from Provident Bank prior to permitting a change in ownership of more than 25% of the stock or other equity interests of us and our subsidiaries or permit us or any of such entities to enter into any merger or consolidation or sell or lease substantially all of our or its assets, and (v) obtaining prior written consent of Provident Bank, subject to exceptions, to make payments of debt to any person or entity or making any distributions of any kind to any officers, employees or members. The revolving credit agreement also contains certain financial covenants which we are required to maintain including, but not limited to tangible net worth, current ratio, total liabilities to net worth ratio, debt service coverage and current ratio, as more fully described in the revolving credit agreement.

Events of default, include, but are not limited to: (i) a determination by Provident Bank that the financial condition of us or any person or entity that generally is now or hereafter liable, directly, contingently or otherwise obligated to pay Provident Bank under the revolving credit agreement (Other Obligor) is unsatisfactory, (ii) we or an Other Obligor becoming insolvent, (iii) the suspension of business, or commission of an act amounting to business failure by us or any Other Obligor, and (iv) a change in more than 25% of the ownership of us without the prior written consent of Provident Bank. Upon an event of default, the lender may (i) accelerate and call immediately due and payable all of the unpaid principal, accrued interest and other sums due as of the date of default, (ii) impose the default rate of interest with or without acceleration, (iii) file suit against us or any Other Obligor, (iv) seek specific performance or injunctive relief to enforce performance of the our obligations (v) exercise any rights of a secured creditor under the Uniform Commercial Code, (vi) cease making advances or extending credit to us and stop and retract the making of any advances which we may have requested, and (vii) reduce the maximum amount we are permitted to borrow under the revolving credit agreement. We have also authorized Provident Bank, upon a default, but without prior notice to or demand upon us and without prior opportunity of us to be heard, to institute an action for replevin, with or without bond as Provident Bank may elect, to obtain possession of any of the collateral.

At December 31, 2005, we were in compliance with the financial covenants contained in our revolving credit agreement.

If our customer base were to remain constant, after giving effect to the sale of our secure network services business, we expect to have approximately $5.0 million available on our revolving credit agreement through the next twelve months. If we were to obtain a significant new contract or make contract modifications, we are generally required to invest significant initial start-up funds which are subsequently billed to customers and as a result may be required to draw down on our credit facility.

The revolving credit agreement prohibits the payment of dividends or distributions as well as limits the payment of principal or interest on our subordinated debt, which is not paid until we obtain a waiver from the bank.

In conjunction with the acquisition of AlphaNational, we issued notes to the former AlphaNational shareholders in the aggregate amount of $500,000, with an interest rate of 6% per annum. Based upon final adjustments to the September 30, 2004 closing balance sheet, the aggregate balance of the notes was reduced to $168,000. The notes mature on March 31, 2006. Interest is payable quarterly and in arrears.

During the quarter ended September 30, 2005 and concurrent with the amendment and restatement of our revolving credit agreement, we have received consent from the Bank to pay an aggregate principal amount of $1.4 million and aggregate accrued interest amount of $100,000 on the 7% convertible subordinated debentures and 8% promissory notes. We used a portion of the proceeds from the sale of the secure network services business to pay the entire principal amount of the 7% convertible subordinated debentures and $1.0 million in the reduction in the principal amount of the 8% promissory notes dated October 8, 1998 and October 13, 1998. After giving effect to these payments the aggregate principal amount to the holders of the 8% promissory notes was $1.0 million. Interest payable to the affiliates was approximately $127,000 at December 31, 2005.

Our subordinated debt agreements with Nancy Scurlock and the Arch C. Scurlock Children s Trust, which are affiliates, totaled $1.0 million at December 31, 2005. Pursuant to a subordination agreement between our lender and the subordinated debt holders, principal repayment and interest payable on the subordinated debt agreements may not be paid without the consent of the bank. At December 31, 2005, the affiliates held in the aggregate $500,000 and $500,000 face amounts of our 8% promissory notes, with an aggregate outstanding principal balance of $1.0 million. On June 29, 2005, we amended our 8% promissory notes with these affiliates to extend the maturity date to July 1, 2007, which is the next day immediately succeeding the expiration of the revolving credit agreement. The holders of our 8% promissory also waived any rights they had regarding the acceleration of such notes and debentures and any notice which may have been required to be given by us of an event of default under the notes or debentures which may have arisen or occurred prior to June 29, 2005.

Off Balance Sheet Arrangements

In conjunction with a government contract, we act as a conduit in a financing transaction on behalf of a third party. We routinely transfer receivables to a third party in connection with equipment sold to end users. The credit risk passes to the third party at the point of sale of the receivables. Under the provisions of Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, transfers were accounted for as sales, and as a result, the related receivables have been excluded from the accompanying consolidated balance sheets. The amount paid to us for the receivables by the transferee is equal to our carrying value and therefore there is no gain or loss recognized. The end user remits its monthly payments directly to an escrow account held by a third party from which payments are made to the transferee and us, for various services provided to the end users. We provide limited monthly servicing whereby we invoice the end user on behalf of the transferee. The off-balance sheet transactions had no impact on our liquidity or capital resources. We are not aware of any event, demand or uncertainty that would likely terminate the agreement or have an adverse affect on our operations.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Errors Corrections- a replacement of APB Opinion No. 20 and FASB Statement No. 3, (SFAS No. 154) . SFAS No. 154 changes the requirement for the accounting and reporting of a change in an accounting principle. SFAS No. 154 is effective for accounting changes and correction of errors in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of this statement to have a material impact on its financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R. SFAS No. 123R addresses the requirements of an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost of such awards will be recognized over the period during which an employee is required to provide services in exchange for the award. The Company will be required to adopt SFAS 123R during the first quarter of fiscal year 2007. The Company is currently evaluating the impact that this pronouncement will have on its financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to changes in interest rates, primarily as a result of using bank debt to finance our business. The floating interest debt exposes us to interest rate risk, with the primary interest rate exposure resulting from changes in the prime rate. It is assumed in the table below that the prime rate will remain constant in the future. Adverse changes in the interest rates or our inability to refinance our long-term obligations may have a material negative impact on our results of operations and financial condition.

The definitive extent of the interest rate risk is not quantifiable or predictable because of the variability of future interest rates and business financing requirements. We do not customarily use derivative instruments to adjust our interest rate risk profile.

The information below summarizes our sensitivity to market risks as of December 31, 2005. The table presents principal cash flows and related interest rates by year of maturity of our funded debt. Note 6 to the consolidated financial statements in our annual report on Form 10-K for the year ended March 31, 2005 contains descriptions of funded debt and should be read in conjunction with the table below.

(Amounts in thousands) Debt obligations	Period Ending December 31, 2005	Fair Value December 31, 2005
Revolving credit agreement at the prime rate plus 1/4%. Due June 30, 2007. Average interest rate of 7.50%.	7,028	7,028
8% subordinated notes payable to affiliate due July 1, 2007	1,000	1,000
6% notes issued to former AlphaNational shareholders	168	168
Notes Payable GMAC interest rate 0.0% to 1.9% due in 48 and 36 months.	4	4
Total fixed rate debt	1,172	1,172
Total debt	8,200	8,200

At December 31, 2005, we had $8.2 million of debt outstanding of which $1.2 million bears fixed interest rates. If the interest rates charged to us on our variable rate debt were to increase significantly, the effect could be materially adverse to our future operations.

We conduct a limited amount of business overseas, principally in Western Europe. At the present, all transactions are billed and denominated in U.S. dollars and consequently, we do not currently have any material exposure to foreign exchange rate fluctuation risk.

Item 4. Controls and Procedures

Quarterly Evaluation of the Company s Disclosure Controls and Internal Controls. The Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the Act), as of the end of the period covered by this Form 10-Q (Disclosure Controls). This evaluation (Disclosure Controls Evaluation) was done under the supervision and with the participation of management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO).

The Company s management, with the participation of the CEO and CFO, also conducted an evaluation of the Company s internal control over financial reporting, as defined in Rule 13a-15(f) of the Act, to determine whether any changes occurred during the period ended December 31, 2005 that have materially affected, or are reasonably likely to

materially affect, the Company s internal control over financial reporting (Internal Controls Evaluation).

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Limitations on the Effectiveness of Controls. Control systems, no matter how well conceived and operated, are designed to provide a reasonable, but not an absolute, level of assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. The Company conducts periodic evaluation of its internal controls to enhance, where necessary, its procedures and controls.

Conclusions. Based upon the Disclosure Controls Evaluation, the CEO and CFO have concluded that the Disclosure Controls are effective in reaching a reasonable level of assurance that information required to be disclosed by the Company in the reports it files or submits under the Act is accumulated, recorded, processed, summarized, communicated to the Company s management to permit timely decisions regarding disclosure, and reported within the specified time periods in the Securities and Exchange Commission s rules and forms.

There were no changes in internal controls over financial reporting as defined in Rule 13a-15(f) of the Act that have materially affected, or are reasonably likely to materially affect internal controls over the Company s internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Except as discussed below, there are no material pending legal proceedings to which we are a party. From time to time, we are engaged in ordinary routine litigation incidental to our business. While we cannot predict the ultimate outcome of these matters, or other routine litigation matters, it is management s opinion that the resolution of these matters should not have a material effect on our financial position or results of operations.

On August 17, 2005, the Company was named as a defendant in a lawsuit filed by BIS Computer Services, Inc. in the United States District Court for the Eastern District of Virginia alleging that the Company breached its contract with BIS Computer Services, Inc., a subcontractor, did not act in good faith, and further did not comply with the terms and conditions of the agreement. The plaintiff sought compensatory damages of approximately $1.6 million and punitive damages of $350,000 as well certain prejudgment and post judgment interest. If the plaintiff prevails, the Company s results of operations, cash flows or financial position would be materially affected.

On January 27, 2006, the Company was granted a motion for summary judgment and the lawsuit was dismissed. Subsequently, the plaintiff filed an appeal of the ruling. Based on all of the currently available information, and discussions with legal counsel representing the Company in connection with the matter, Company management has determined that a reserve for potential loss is not necessary at this time.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibit 10	Solutions Engagement Agreement
Exhibit 31.1	Certification of Charles L. McNew, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2	Certification of Joseph Sciacca, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	Certification of Charles L. McNew, Chief Executive Officer, pursuant to 18 U.S.C. Section 1350 (Section 906 of the Sarbanes-Oxley Act of 2002)
Exhibit 32.2	Certification of Joseph Sciacca, Chief Financial Officer, pursuant to 18 U.S.C. Section 1350 (Section 906 of the Sarbanes-Oxley Act of 2002)

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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.

HALIFAX CORPORATION
(Registrant)

Date: February 14, 2006	By: /s/ Charles L. McNew
	Charles L. McNew President & Chief Executive Officer (principal executive officer)
Date: February 14, 2006	By: /s/ Joseph Sciacca
	Joseph Sciacca Vice President, Finance & Chief Financial Officer (principal financial officer)

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