HALIFAX CORP
Form 10-Q
February 13, 2007

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, 2006

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 3,175,206 shares of common stock outstanding as of February 1, 2007.

HALIFAX CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

HALIFAX CORPORATION CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	December 31, 2006 (unaudited)	March 31, 2006
ASSETS		
CURRENT ASSETS		
Cash	$ 112	$ 400
Restricted cash	665	625
Trade accounts receivable, net	10,928	11,415
Inventory, net	5,884	6,363
Prepaid expenses and other current assets	383	722
Deferred tax asset	985	1,332
TOTAL CURRENT ASSETS	18,957	20,857
PROPERTY AND EQUIPMENT	1,154	1,381
GOODWILL	2,918	2,918
INTANGIBLE ASSETS	1,027	1,295
OTHER ASSETS	123	130
DEFERRED TAX ASSET	977	828
TOTAL ASSETS	$ 25,156	$ 27,409
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 2,888	$ 3,975
Accrued expenses	3,182	3,160
Notes payable		168
Income taxes payable	20	331
Deferred maintenance revenue	3,141	3,515
Current portion of long-term debt	33	34
TOTAL CURRENT LIABILITIES	9,264	11,183
LONG-TERM BANK DEBT	6,444	6,891
SUBORDINATED DEBT PAYABLE TO AFFILIATE	1,000	1,000
OTHER LONG-TERM DEBT	128	154
DEFERRED INCOME	174	218

TOTAL LIABILITIES		17,010		19,446
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 3,431,890 as of December 31, 2006 and March 31, 2006				
Outstanding 3,175,206 shares as of December 31, 2006 and March 31, 2006		828		828
Additional paid-in capital		9,043		9,017
Accumulated (deficit)		(1,513)		(1,670)
Less Treasury stock at cost 256,684 shares		(212)		(212)
TOTAL STOCKHOLDERS EQUITY		8,146		7,963
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	25,156	$	27,409

See notes to the Consolidated Financial Statements.

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HALIFAX CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED DECEMBER 31, 2006 AND 2005 (UNAUDITED)

(Amounts in thousand, except share data)	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005 Restated	Nine Months Ended December 31, 2006	Nine Months Ended December 31, 2005 Restated
Revenues	$ 12,603	$ 13,390	$ 37,718	$ 42,027
Costs	11,202	13,076	33,516	39,437
Gross margin	1,401	314	4,202	2,590
Selling and marketing	243	346	785	1,113
General and administrative	847	913	2,594	2,735
Severance costs		144		144
Operating income (loss)	311	(1,089)	823	(1,402)
Other income	(8)		(23)	(5)
Interest expense	171	135	492	458
Income (loss) before income taxes	148	(1,224)	354	(1,855)
Income tax expense (benefit)	97	(441)	197	(665)
Income (loss) from continuing operations	51	(783)	157	(1,190)
Income from discontinued operations (net of taxes of $164)				310
Gain on sale of discontinued operations (net of taxes of $3,900)		2,182		2,182
Net income	$ 51	$ 1,399	$ 157	$ 1,302
Earnings (loss) per share basic				
Continuing operations	$ .02	$ (.25)	$ .05	$ (.37)
Discontinued operations				.10
Gain on sale of discontinued operations		.69		.68
	$ .02	$ .44	$ .05	$ .41

Earnings (loss) per share diluted				
Continuing operations	$ .02	$ (.25)	$ .05	$ (.37)
Discontinued operations				.10
Gain on sale of discontinued operations		.69		.68
	$ .02	$ .44	$ .05	$ .41
Weighted average number of shares outstanding				
Basic	3,175,206	3,172,206	3,175,206	3,171,992
Diluted	3,178,957	3,183,370	3,179,171	3,187,613

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, 2006 (UNAUDITED)

(Amounts in thousands)	Nine Months Ended December 31,	
	2006	2005 Restated
Cash flows from operating activities:		
Net income	$ 157	$ 1,302
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	742	809
Deferred tax expense (benefit)	197	(253)
Share-based compensation	27	
Gain on sale of discontinued operations		(2,182)
Changes in operating assets and liabilities:		
Accounts receivable	484	(922)
Inventory	479	(723)
Prepaid expenses and other assets	348	(254)
Accounts payable and accrued expenses	(1,065)	(4,204)
Income taxes payable	(311)	(106)
Deferred maintenance revenue	(375)	(247)
Deferred income	(44)	(45)
Total adjustments	482	79
Net cash provided by (used in) operating activities	639	(6,825)
Cash flows from investing activities:		
Acquisition of property and equipment	(246)	(248)
Proceeds from sale of discontinued operations		13,057
Restricted cash	(40)	(2,024)
Payment for purchase of acquired entities (net of cash received)		(330)
Net cash (used in) provided by investing activities	(286)	10,455
Cash flows from financing activities:		
Proceeds from bank borrowing	24,883	33,080
Retirement of bank debt	(25,330)	(35,515)
Retirement of other-long-term debt	(26)	(1,416)
Retirement of acquisition debt	(168)	(494)

Issuance of common stock				6
Net cash used in financing activities		(641)		(4,339)
Net decrease in cash		(288)		(709)
Cash at beginning of period		400		1,264
Cash at end of period	$	112	$	555
Supplemental Disclosure of Cash Flow Information:				
Cash paid for interest	$	548	$	268
Cash paid for income taxes	$	321	$	66

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, 2006, 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, 2006 and 8-K dated January 24, 2007 filed with the Securities and Exchange Commission. The prior period financial statements have been restated as discussed in Note 2.

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 (SNS). 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. On July 8, 2005, $1.0 million of the amount held in escrow to serve as security to obtain certain consents was released to the Company. Certain other 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 plus accrued interest remains in escrow (restricted cash on the accompanying balance sheet) as security for the payment of the Company s indemnification obligations pursuant to the asset purchase agreement. If there were no such obligations, these funds would have been released to the Company eighteen (18) months following the date of closing, or December 31, 2006. However, on December 28, 2006, we received a Notice of Claim from Indus, pursuant to which Indus alleged various breaches of certain representations and warranties in the Agreement by us. Indus takes the position that these alleged breaches entitle Indus to indemnification. As a result, Indus further takes the position that the entire amount remaining in Escrow which totaled $625,000, plus interest, should be disbursed to Indus. The Company delivered a Response Notice to the escrow agent and Indus and disputed the claims of Indus set forth in its Notice of Claim. The Company believes the claim is without merit and is working vigorously to resolve the matter. Therefore, no adjustments to the accompanying financial statements have been made relating to this matter.

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 required 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 a result of the sale, SNS results of operations and related assets and liabilities have been classified as discontinued operations for all periods presented.

Subsequent to its year end, the Company identified an inconsistency in our original reporting of this transaction contained in our annual report on Form 10-K for the year ended March 31, 2006. In applying the guidance contained in paragraph 39 of SFAS No. 142 in recording the gain, goodwill should have been allocated to the basis of SNS based on its relative fair value. The effect of this adjustment would have been to reduce the loss from

operations from approximately $4.7 million ($1.41 per share) to $1.5 million ($.40 per share), as there would not have been an impairment of goodwill, with an offsetting reduction of the related gain on sale from approximately $5.7 million ($1.80 per share) to $2.5 million ($.79 per share). Net income as reported did not change as a result of this inconsistency. On January 18, 2007, management of the Company completed its review and determined that a restatement of its annual report filed on Form 10-K for the year ended March 31, 2006 and quarterly reports for the quarters ended June 30, 2005, September 30, 2005 and December 31, 2005 was necessary. The Company is in the process of amending its filings.

The financial information presented for the three and nine months ended December 31, 2005 has been restated to reflect the correction of the items discussed above. The following table summarizes the corrections to the financial information for the three and nine months ended December 31, 2005.

	Three Months Ended December 31, 2005		Nine Months Ended December 31, 2005	
(Amounts in thousand, except share data)	As reported	Restated	As reported	Restated
Goodwill impairment loss	$ 3,211	$	$ 3,211	$
Operating loss	(4,300)	(1,809)	(4,613)	(1,402)
Loss from continuing operations	(3,994)	(783)	(4,401)	(1,190)
Income from discontinued operations (net of taxes of $164)			310	310
Gain on sale of discontinued operations (net of taxes of $3,900)	5,393	2,182	5,393	2,182
Net income	$ 1,399	$ 1,399	$ 1,302	$ 1,302
Earnings (loss) per share basic and diluted				
Continuing operations	$ (1.26)	$ (.25)	$ (1.39)	$ (.37)
Discontinued operations			.10	.10
Gain on sale of discontinued operations	1.70	.69	1.70	.68
	$ .44	$ 44	$ .41	$ .41

Note 3 Accounts Receivable consisted of the following:
(amounts in thousands)

	December 31, 2006	March 31, 2006
Amounts billed	$ 10,666	$ 11,079
Amounts unbilled	516	501
Allowance for doubtful accounts	(254)	(165)

Accounts receivable, net	$	10,928	$	11,415

Note 4 Inventory

Inventory consists principally of spare parts, computers and computer peripherals, hardware and software. Inventory is recorded net of allowances for inventory valuation reserve of $827,000 at December 31, 2006 and March 31, 2006.

Note 5 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. 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.

Management regularly evaluates the realizability of its deferred tax assets given the nature of its operations and the tax jurisdictions in which it operates. The Company adjusts its valuation allowance from time to time based on such evaluations. Based upon the Company s historical taxable income, when adjusted for non-recurring items, net operating loss carryback potential and estimates of future profitability, management has concluded that, in its judgment, the deferred tax asset remains fully realizable, and a valuation allowance need not be established.

Note 6 Debt Obligations

Bank Debt

On July 6, 2006, the Company and its subsidiaries amended and restated the Amended and Restated Loan and Security Agreement (revolving credit agreement) with Provident Bank. The maturity date is June 30, 2008. Effective December 27, 2006, the Company reduced its maximum availability under the agreement from $12.0 million to $10.0 million due to excess borrowing capacity. Such amount may be restored in the future if required for operations. There was no change to the auxiliary revolver facility with a maximum borrowing capacity of $1.0 million, which is based upon a borrowing base of up to 25% of our eligible inventory. The Company is permitted to use the proceeds of the auxiliary revolver facility for costs related to the commencement of any new contract.

The amount outstanding under the revolving credit 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, 2006, $6.4 million was outstanding and $3.6 million was available to us. At December 31, 2006, there were no advances on the auxiliary revolver facility. The interest rate at December 31, 2006 was 8.5%.

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.

At December 31, 2006, the Company was in compliance with the financial covenants contained in its revolving credit agreement.

For more information on the Company s revolving credit agreement see Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Notes Payable

In conjunction with the September 30, 2004 acquisition of AlphaNational Technology Services, Inc., the Company issued notes to the former AlphaNational shareholders in the aggregate amount of $168,000, with an interest rate of 6%. The notes and accrued interest were paid in full in April 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 are the Children s Trust and Nancy M. Scurlock. The Company 8% promissory notes are subordinated to the revolving credit agreement described above.

With the amendment of its revolving credit agreement with Provident Bank on July 6, 2006, the Company s 8% promissory notes maturity date was extended to July 1, 2008, which date is the next day immediately succeeding the expiration of the revolving credit agreement. As of December 31, 2006, the principal balance on 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 held 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 $122,000 at December 31, 2006.

Note 7 Stock Based Compensation

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payments, (SFAS No. 123R) which requires that compensation costs related to share-based payment transactions be recognized in financial statements. SFAS No. 123R requires all companies to measure compensation costs for all share-based payments at fair value, and eliminates the option of using the intrinsic method of accounting provided for in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) which generally resulted in no compensation expense recorded in the financial statements related to the grant of stock options to employees and directors if certain conditions were met.

Effective April 1, 2006, the Company adopted SFAS No. 123R using the modified prospective method. Under this method, compensation costs for all awards granted after the date of adoption and the unvested portion of previously granted awards outstanding at the date of adoption will be measured at estimated fair value and included in operating expenses over the vesting period during which an employee provides service in exchange for the award. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS No. 123R.

Prior to the adoption of SFAS No. 123R, the tax benefits resulting from the exercise of stock options were immaterial to the financial statements or operating cash flows in the consolidated statements of cash flows. In accordance with SFAS No. 123R, for the period beginning April 1, 2006, excess tax benefits from the exercise of stock options are presented as financing cash flows. There were no options exercised during the nine months ended December 31, 2006 and as a result excess tax benefits were $0 for the three and nine months then ended.

As a result of adopting SFAS No. 123R, the Company recorded $8,000 and $27,000 of stock-based compensation expense, in its statement of operations and is included in general and administrative expenses for the three and nine months ended December 31, 2006. This stock-based compensation expense did not materially impact basic and diluted earnings per share for the three and nine months ended December 31, 2006.

Fair Value Determination

The fair value concepts were not changed significantly in SFAS No. 123R; however, in adopting this Standard, companies must choose among alternative valuation models and amortization assumptions. The Company has elected to use both the Black-Scholes option pricing model and straight-line amortization of compensation expense over the requisite service period of the grant. The Company will reconsider use of the Black-Scholes option pricing model if additional information becomes available in the future that indicates another model would be more appropriate, or if grants issued in future periods have characteristics that cannot be reasonably estimated using this model.

There were no options grants during the quarter ended December 31, 2006. During the quarter ended September 30, 2006, the Company issued 97,300 options. The weighted average grant date fair value of the options was $1.63. The Company s options expire 10 years after grant date. In calculating fair value, the following weighted-average assumptions were used for options granted.

Expected Volatility. The expected volatility of the Company s shares was estimated based upon the historical volatility of the Company s share price over a period of 6.25 years, as being representative of the price volatility expected in the future. Based on the guidance provided in SFAS No. 123R the monthly volatility calculated was 48.99%.

Risk-free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes valuation method on the implied yield available on a U.S. Treasury note on the applicable grant date, with a term equal to the expected

term of the underlying grants. The risk-free interest rates used in valuing options granted during the three months ended September 30, 2006 were 4.94%

Dividend Yield. The Black-Scholes valuation model calls for a single expected dividend yield as an input. The Company has not paid dividends in the past nor does it expect to pay dividends in the future. As such, the Company used a dividend yield percentage of zero.

Expected Term. The expected term used in the Company s Black-Scholes model is 6.25 years. The contractual term of the options is 10 years.

In prior years, while accounting for stock options under APB No. 25 and disclosing a pro forma expense calculation under SFAS No. 123, the Company recognized the effect of forfeitures as they occurred. In accordance with SFAS No. 123R, the Company estimates forfeitures on date of grant and is recognizing compensation expense only for those share-based awards that are expected to vest.

As of December 31, 2006, there was $155,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements. This cost is expected to be fully amortized in five years, with 40% of the total amortization cost being recognized within the next 24 months.

Stock Option Activity

During the quarter ended December 31, 2006, there were no grants of stock options to purchase shares of common stock. There were no exercises of or terminations/expirations of options to purchase shares of common stock.

The following table summarizes the information for options outstanding and exercisable under the Company s 2005 Stock Option and Incentive Plan at December 31, 2006.

		Options Outstanding			
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life	Options Outstanding Weighted Average Exercise Price	Options Exercisable	Options Exercisable Weighted Average Exercise price
$3.40	27,800	9.25 years	$3.40	27,800	$3.40
3.00	97,300	9.50 years	3.00		

The following table summarizes the information for options outstanding and exercisable under the Company s 1994 Key Employee Stock Option Plan and Non-Employee Directors Stock Option Plan at December 31, 2006.

		Options Outstanding			
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life	Options Outstanding Weighted Average Exercise Price	Options Exercisable	Options Exercisable Weighted Average Exercise price
$ 10.25	24,250	.75 years	$ 10.25	24,250	$ 10.25
7.03	10,500	1.75 years	7.03	10,500	7.03
5.57-7.56	77,000	3.00 years	6.23	77,000	6.23
5.38-7.06	64,500	3.50 years	5.80	64,500	5.80
1.80-4.05	76,000	5.00 years	3.49	76,000	3.49
3.10-5.00	45,667	6.00 years	3.51	31,542	3.69
4.11-5.70	18,000	6.50 years	4.55	13,388	4.41
4.45-5.02	81,000	7.60 years	4.58	78,475	4.59
$ 2.60-$7.56	396,917		$ 5.18	375,655	$ 5.26

The intrinsic value of stock options outstanding at December 31, 2006 was approximately $10,100.

Pro Forma Disclosures

Under the modified prospective method, results for the three and nine month ended December 31, 2005 were not restated to include stock option expense. The previously disclosed pro forma effects of recognizing the estimated fair value of stock-based employee compensation, which historically was calculated using the Black-Scholes pricing model, for the three and nine months ended December 31, 2005 are presented below.

(Amounts in thousands, except share data)	Three months ended December 31, 2005		Nine months ended December 31, 2005	
Net income as reported	$	1,399	$	1,302
Add: Compensation expense under APB No 25				
Deduct: Stock-based compensation expense under the fair value method, net of tax		20		60
Pro-forma net income	$	1,379	$	1,242
Earnings per common share (as reported):				
Basic	$	.44	$	.41
Diluted	$	.44	$	.41
Pro-forma earnings per common share:				
Basic	$	.43	$	.39
Diluted	$	.43	$	.39

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 8 New accounting standards

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes , which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN No. 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN No. 48 will be effective for fiscal year beginning April 1, 2007 and the Company is in the process of determining the effect, if any, the adoption of FIN No. 48 will have on its financial condition or results of operations.

In September 2006, the FASB issued FASB Statement No. 157 (SFAS 157), Fair Value Measurements . SFAS 157 prescribes a single definition of fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The accounting provisions of SFAS 157 will be effective for the Company beginning April 1, 2008. The Company does not believe the adoption of SFAS 157 will have a material impact on its financial condition or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is material, companies will record the

effect as a cumulative effect adjustment to beginning of year retained earnings. SAB 108 will be effective for the Company beginning March 31, 2007. The Company is does not believe that the adoption of SAB 108 will have a material impact on its financial condition or results of operations.

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, 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, 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. 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 (SNS). 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 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 growing customer base. 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. 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, 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.

The industry in which we operate has experienced unfavorable economic conditions and competitive challenges. We continue to experience 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. It has been our experience that longevity and quality 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 pursuant to which we sold substantially all of the assets and certain liabilities of our secure network services business (SNS). 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, $1.0 million of the amount 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 plus accrued interest remains in escrow as security for the payment of the Company s indemnification obligations pursuant to the asset purchase agreement. If there were no such obligations, these funds would have been released to the Company eighteen (18) months following the date of closing, or December 31, 2006. However, on December 28, 2006, we received a Notice of Claim from Indus, pursuant to which Indus alleged various breaches of certain representations and warranties in the Agreement by us. Indus takes the position that these alleged breaches entitle Indus to indemnification. As a result, Indus further takes the position that the entire amount remaining in Escrow which totaled $625,000, plus interest, should be disbursed to Indus. We delivered a Response Notice to the escrow agent and Indus and disputed the claims of Indus set forth in its Notice of Claim. We believe the claim is without merit and are working vigorously to resolve the matter. (See Note 2 of the notes to Consolidated Financial Statements contained in the Company s Form 10-Q for the quarter ended December 31, 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.

Subsequent to our year end, we have identified an inconsistency in our original reporting of this transaction contained in our annual report on Form 10-K for the year ended March 31, 2006. In applying the guidance contained in paragraph 39 of SFAS No. 142 in recording the gain, goodwill should have been allocated to the basis of SNS based

on its relative fair value. The effect of this adjustment would have been a reduction to the loss from operations from approximately $4.7 million to $1.5 million, as there would not have been an impairment of goodwill,

with an offsetting reduction of the related gain on sale from approximately $5.7 million to $2.5 million. Net income as reported did not change as a result of this inconsistency. On January 18, 2007, management of the Company completed its review and determined that a restatement of its annual report filed on Form 10-K for the year ended March 31, 2006 and quarterly reports for the quarters ended June 30, 2005, September 30, 2005 and December 31, 2005 was necessary. We are in the process of amending our filings.

The financial information presented for the three and nine months ended December 31, 2005 has been restated to reflect the correction of the items discussed above. The following table summarizes the corrections to the financial information for the three and nine months ended December 31, 2005.

	Three Months Ended December 31, 2005		Nine Months Ended December 31, 2005	
(Amounts in thousand, except share data)	As reported	Restated	As reported	Restated
Goodwill impairment loss	$ 3,211	$	$ 3,211	$
Operating loss	(4,300)	(1,809)	(4,613)	(1,402)
Loss from continuing operations	(3,994)	(783)	(4,401)	(1,190)
Income from discontinued operations (net of taxes of $164)			310	310
Gain on sale of discontinued operations (net of taxes of $3,900)	5,393	2,182	5,393	2,182
Net income	$ 1,399	$ 1,399	$ 1,302	$ 1,302
Earnings (loss) per share basic and diluted				
Continuing operations	$ (1.26)	$ (.25)	$ (1.39)	$ (.37)
Discontinued operations			.10	.10
Gain on sale of discontinued operations	1.70	.69	1.70	.68
	$ .44	$ 44	$ .41	$ .41

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, 2006 and 2005, respectively, and should be read in conjunction with the consolidated financial statements and notes thereto.

nounts in thousands, except share data)	Three months ended December 31,				Nine months ended December 31,			
sults of Operations	2006	2005 Restated	Change	%	2006	2005 Restated	Change	%
venues	$ 12,603	$ 13,390	(787)	(6%)	37,718	$ 42,027	(4,309)	(10
sts	11,202	13,076	(1,874)	(14%)	33,516	39,437	(5,921)	(15
rcent of revenues	89%	98%			89%	94%		
oss margin	1,401	314	1,087	345%	4,202	2,590	1,612	62
rcent of revenues	11%	2%			11%	6%		
ling and marketing	243	346	(103)	(30%)	785	1,113	(328)	(29
rcent of revenues	2%	3%			2%	3%		
neral & administrative	847	913	(66)	(7%)	2,594	2,735	(141)	(5
rcent of revenues	7%	7%			7%	7%		
verance costs		144	(144)	NM		144	(144)	NM
erating income (loss)	311	(1,089)	1,400	129%	823	(1,402)	2,225	159
rcent of revenues	3%	(8%)			2%	(3%)		
her income	(8)		8	NM	(23)	(5)	18	NM
erest expense	171	135	36	25%	492	458	34	7
ome(loss) before income tax	148	(1,224)	1,372	112%	354	(1,855)	2,209	119
ome tax expense (benefit)	97	(441)	538	122%	197	(665)	862	130
ome (loss) from continuing operations	51	(783)	834	107%	157	(1,190)	1347	113
ome from discontinued operations (net taxes)						310		NM
in on sale of discontinued operations t of taxes)		2,182	(2,182)	NM		2,182	(2,182)	NM
t income	$ 51	$ 1,399	(1,348)	(96%)	$ 157	$ 1,302	(1,145)	(88
rnings (loss) per share basic:								
ntinuing operations	$ .02	$ (.25)			$ .05	$ (.37)		
scontinued operations						10		
in on sale of discontinued operations		69				.68		
	$ .02	$ 44			$ .05	$ .41		

rnings (loss) per share diluted:				
ntinuing operations	$ .02	$ (.25)	$ .05	$ (.37)
scontinued operations				10
in on sale of discontinued operations		69		.68
	$ .02	$ 44	$ .05	$ .41
eighted average number of common ares outstanding				
sic	3,175,206	3,172,206	3,175,206	3,171,992
uted	3,178,957	3,183,370	3,179,171	3,187,613

No effect is given to dilutive securities for loss periods.

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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:

	Three Months Ended December 31,				Nine Months Ended December 31,			
(Dollar amounts in thousands*)*	2006	2005	Change	%	2006	2005	Change	%
Services	$ 12,052	$ 12,559	$ (507)	(4%)	$ 35,674	$ 38,948	$ (3,274)	(8%)
Product held for resale	551	831	(280)	(34%)	2,044	3,079	(1,035)	(34%)
Total Revenue	$ 12,603	$ 13,390	$ (787)	(6%)	$ 37,718	$ 42,027	$ (4,309)	(10%)

Revenues for the three months ended December 31, 2006 decreased 6%, or $787 thousand, to $12.6 million from $13.4 million for the three months ended December 31, 2005. For the nine months ended December 31, 2006, revenues decreased 10%, or $4.3 million, from $42 million to $37.7 million. Revenues from services for the three months ended December 31, 2006 decreased 4%, or $507,000, to $12.1 million from $12.6 million for the three months ended December 31, 2005. For the nine months ended December 31, 2006, services revenues decreased 8%, or $3.3 million, to $35.6 million from $38.9 million for the comparable period ended December 31, 2005. The decrease in revenues for the three and nine month periods was attributable to our resignation from a large, nationwide enterprise maintenance contract, partially offset by new, more profitable business.

For the three months ended December 31, 2006, product held for resale decreased $280,000, or 34%, from $831,000 for the three months ended December 31, 2005 to $551,000 for the three months ended December 31, 2006. For the nine months ended December 31, 2006, product held for resale decreased 34%, or $1.0 million, from $3.1 million for the nine months ended December 31, 2005 to $2.0 million for the three months ended December 31, 2006. The decrease in product held for resale was the absence of several large one time orders during the three and nine months ended December 31, 2006. We have de-emphasized product sales and intend to focus 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 on-going cost containment efforts continue. We continue to aggressively pursue cost containment strategies and augment our service delivery process with automation tools.

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, negatively impacting profit margins.

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.

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Costs were comprised of the following components:

	Three Months Ended December 31,				Nine Months Ended December 31,			
(Dollar amounts in thousands)	2006	2005	Change	%	2006	2005	Change	%
Service costs	$ 10,701	$ 12,304	$ (1,603)	(13%)	$ 31,648	$ 36,620	$ (4,972)	(14%)
Product costs	501	772	(271)	(35%)	1,868	2,817	(949)	(34%)
Total costs	$ 11,202	$ 13,076	$ (1,874)	(14%)	$ 33,516	$ 39,437	$ (5,921)	(15%)

Total costs for the three months ended December 31, 2006 decreased $1.9 million, to $11.2 million, or 14%, from $13.1 million for the same period in 2005. For the nine months ended December 31, 2006, total costs decreased $5.9 million, or 15%, to $33.5 million compared to $39.4 million for the comparable period in 2005. As discussed above, the decease in service costs was primarily related to our resignation from a large, nationwide, loss generating enterprise maintenance contract. In addition, initial start-up costs related to the start of certain new contracts had a negative impact on our third quarter results. For the three and nine months ended December 31, 2006, product costs decreased as a result of decreased revenues.

Gross Margin

As a percentage of revenues, gross margin was 11% for the three months ended December 31, 2006 compared to 2% the same three month period ended December 31, 2005. The gross margin percentage was 11% for the nine months ended December 31, 2006 and 6% for the nine months ended December 31, 2005, respectively. For the three months ended December 31, 2006, our gross margins improved 346% growing to $1.4 million, from $314,000 in the same period ended December 31, 2005. For the nine months ended December 31, 2006, gross margin increased 62% from $2.6 million in fiscal year 2005 to $4.2 million. As discussed above, the improvement in our gross margin was the result of our resignation from a large, nationwide, loss generating enterprise maintenance contract, and increases in new, more profitable business.

Selling and Marketing Expense

Selling and marketing expense consists primarily of salaries, commissions, travel costs and related expenses. Selling and marketing expense was $243,000 for the three months ended December 31, 2006 compared to $346,000 for the three months ended December 31, 2005, a decrease of $103,000, or 30%. For the nine months ended December 31, 2006, selling and marketing expense decreased from $785,000 to $1.1 million a 29% decrease for the nine months ended December 31, 2005. The decrease in selling and marketing expense was the result of reduced personnel costs.

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, 2006, general and administrative expenses decreased from $913,000 to $847,000 compared to the three months ended December 31, 2005, a decrease of 7%. For the nine months ended December 31, 2006, general and administrative expenses decreased from $2.7 million for the nine months ended December 31, 2005 to $2.6 million for the nine months ended December 31, 2006, a decrease of approximately $141,000. The primary reason for the decrease in general and administrative expenses was decreases in personnel costs and depreciation expense. Various factors such as changes in the insurance markets and related costs associated with complying with new Securities and Exchange Commission (SEC) regulations and American Stock Exchange requirements, and amending our SEC filings will increase general and administrative expenses and will have a negative impact on our earnings in future periods.

We account for stock-based compensation in accordance with SFAS 123(R), Share-Based Payments. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and recognized as expense over the vesting period. Determining the fair value of the

share-based awards at the grant date requires judgment, including estimated volatility, dividend yield, expected term and

estimated forfeitures of the options granted and are included in general and administrative expense. For the three and nine months ended December 31, 2006, we reported of compensation expense of approximately $8,000 and $27,000, respectively. There was no compensation expense related to stock options for the comparable period last year.

Interest Expense

Interest expense for the three months ended December 31, 2006 was $171,000 compared to $135,000 for the same period in 2005. For the nine months ended December 31, 2006 and December 31, 2005, interest expense was $492,000 and $458,000, respectively. The primary reason for the increase in interest expense during the three months ended December 31, 2006 was higher interest rates and increased borrowings when compared to the three and nine months ended December 31, 2005.

Income Tax Expense (Benefit)

For the three months ended December 31, 2006, we recorded an income tax expense of $97,000 compared to an income tax benefit of $441,000 for the comparable period in 2005. For the nine months ended December 31, 2006, we recorded an income tax expense of $197,000 compared to an income tax benefit of $665,000 for the nine months ended December 31, 2005. The effective tax rate for the three and nine months ended December 31, 2006 was approximately 55% compared to (36) % for the same periods last year. The increase in the tax provision is attributable to the return to profitability. The change in the effective rate from fiscal year 2006 to fiscal year 2007 was attributable to recording a tax benefit due to the losses from continuing operations in fiscal year 2006 compared to tax expense in during fiscal year 2007. The effective tax rate of 55% was a result of increasing income per books for items which are not deductible for tax purposes, including such items as amortization of intangibles and other non deductible items.

Income from discontinued operations

For the nine months ended December 31, 2005, income from discontinued operations was $310,000, net of income taxes of $164,000.

Net income

For the three months ended December 31, 2006, the net income was $51,000 compared to net income of $1.4 million for the comparable period in 2005. For the nine months ended December 31, 2006, we recorded net income of $157,000 compared to net income of $1.4 million for the nine months ended December 31, 2005. As discussed above, the reasons for the improvement in our operating results for the three and nine month periods ended December 31, 2006, was new, profitable business awarded this fiscal year and our resignation from a large, nationwide, loss generating enterprise maintenance contract. During the quarter ended December 31, 2005, we recorded a gain on the sale of SNS of $2.2 million, resulting in net income for the three and none months ended of $1.4 million and $1.3 million, respectively.

Liquidity and Capital Resources

As of December 31, 2006, we had approximately $112,000 of cash on hand. Sources of our cash for the three months ended December 31, 2006 have been from earnings from operations and our revolving credit facility.

We anticipate that our primary sources of liquidity in the fourth fiscal quarter will be cash on hand, cash generated from operating income and the cash available to us under our revolving credit agreement.

Cash generated from operations may be affected by a number of factors. See Item 1A. and Risk Factors in our Form 10-K for the year ended March 31, 2006 for a discussion of the factors that can negatively impact the amount of cash we generate from our operations.

In July 2006, we signed multiple new enterprise maintenance solutions contracts and service agreements with various partners. The annual value of the contracts, in total, was approximately $6.2 million. The Company commenced services under all the contracts/agreements in July 2006. The contracts are expected to generate revenues of approximately $3.0 million over the next twelve months. With the commencement of these new engagements, we also amended and restated our credit and security agreement to provide for an auxiliary revolver facility with a

maximum borrowing capacity of $1.0 million, to provide additional working capital for the start-up costs related to new contracts, should the need arise. There were no advances under the auxiliary revolver facility during the quarter ended December 31, 2006.

Although we have no current 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 future financial performance could be negatively affected by unforeseen factors and unplanned expenses. See Item 1A and Risk Factors in our Form 10-K for the year ended March 31, 2006.

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 may entertain 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 earnings from operations, 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, 2006 and March 31, 2006 we had working capital of $9.7 million. The current ratio was 2.05 at December 31, 2006 compared to 1.87 at March 31, 2006.

Capital expenditures for the nine months ended December 31, 2006 were $246,000 as compared to $248,000 for the same period in 2005. We anticipate fiscal year 2007 technology requirements to result in capital expenditures totaling approximately $500,000. We continue to sublease a portion of our headquarters building which reduces our rent expense by approximately $400,000 annually.

On July 6, 2006, we and our subsidiaries amended and restated our Second Amended and Restated Loan and Security Agreement with Provident Bank to extend the maturity date under the agreement to June 30, 2008. We also amended and restated the agreement to provide for an auxiliary revolver facility with a maximum borrowing capacity of $1.0 million, which is based upon a borrowing base of up to 25% of our eligible inventory. The aggregate amount available to us under the agreement was reduced to $10.0 million effective December 27, 2006, due to excess borrowing capacity. Such amount may be restored in the future if required for operations. We are permitted to use the proceeds of the auxiliary revolver facility for costs related to the commencement of any new contract. The amount outstanding under the agreement bears interest at the bank s prime rate plus one-quarter percent (0.25%). 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%). This amount is payable on December 31, 2006 and on the last day of each quarter until the agreement has been terminated. Additionally, we will pay a fee of $1,000 per month. Advances under the agreement are collateralized by a first priority security interest on all of our assets as defined in the agreement. As of December 31, 2006, $6.4 million was outstanding and $3.6 million was available to us. At December 31, 2006, there were no advances under the auxiliary revolver facility. The interest rate at December 31, 2006 was 8.5%.

The agreement contains representations, warranties and covenants that are that are customary in connection with a transaction of this type. The agreement contains certain covenants including, but not limited to: (i) maintaining our accounts in a cash collateral account 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

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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 nine 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 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 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 agreement (Other Obligor) is unsatisfactory, (ii) we or an Other Obligor becomes insolvent, (iii) the suspension of business, or commission of an act amounting to business failure by us or any Other Obligor, (iv) a change in more than 25% of the ownership of us without the prior written consent of Provident Bank, and (v) the occurrence of an event which is, or with the passage of time or the giving of notice or both, a default under any indebtedness in excess of $100,000 of us or any Other Obligor. Upon an event of default, our 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 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 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, 2006, we were in compliance with the financial covenants contained in our revolving credit agreement.
If our customer base were to remain constant, we expect to have approximately $3.0 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 will generally be 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 $168,000, with an interest rate of 6% per annum. The notes and accrued interest were paid in full in April 2006.
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, 2006. 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. On December 31, 2006, 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. Interest payable to the affiliates was approximately $122,000 at December 31, 2006.
With the amendment and restatement of our Amended and Restated Loan and Security Agreement with Provident Bank, the maturity date of our 8% promissory notes with these affiliates was extended to July 1, 2008, which is the next day immediately succeeding the expiration of the revolving credit agreement.

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

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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.

New Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes , which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN No. 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN No. 48 will be effective for us beginning April 1, 2007 and we are in the process of determining the effect, if any, the adoption of FIN No. 48 will have on our financial condition or results of operations.

In September 2006, the FASB issued FASB Statement No. 157 (SFAS 157), Fair Value Measurements . SFAS 157 proscribes a single definition of fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The accounting provisions of SFAS 157 will be effective for us beginning April 1, 2008. We do not believe the adoption of SFAS 157 will have a material impact on our financial condition or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is material, companies will record the effect as a cumulative effect adjustment to beginning of year retained earnings. SAB 108 will be effective for us beginning March 31, 2007. We do not believe the initial adoption will have a material impact on our financial condition.

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, 2006. The table presents principal cash flows and related interest rates by year of maturity of our funded debt. The carrying value of our debt approximately equals the fair value of the debt. Note 6 to the consolidated financial statements in our annual report on Form 10-K for the year ended March 31, 2006 contains descriptions of funded debt and should be read in conjunction with the table below.

(Amounts in thousands)

Debt obligations	December 31, 2006	
Revolving credit agreement at the prime rate plus 1/4%. Due June 30, 2008. Current interest rate of 8.50%.	$	6,444
8% subordinated notes payable to affiliate due July 1, 2008		1,000
Long Term lease payable		161
Total fixed rate debt		1,161
Total debt	$	7,605

At December 31, 2006, we had $7.6 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, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting (Internal Controls Evaluation).

During fiscal year 2005, we began to evaluate our internal controls over financial reporting in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent auditors addressing these assessments beginning in fiscal year ending March 31, 2008. In this regard, management will be required to

dedicate

internal resources to (i) assess and document the adequacy of internal controls over financial reporting, and (ii) take steps to improve control processes, where appropriate. If we fail to correct any issues in the design or operating effectiveness of internal controls over financial reporting or fail to prevent fraud, current and potential stockholders and customers could lose confidence in our financial reporting, which could harm our business, the trading price of our stock and our ability to retain our current customers and obtain new customers.

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 (i) information required to be disclosed by the Company in the reports that it files or submits under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and (ii) information required to be disclosed by the Company in the reports that it files or submits under the Act is accumulated and communicated to the Company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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.

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.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended March 31, 2006, which could materially affect our business, financial condition or future results. The risk factors in our Annual Report on Form 10-K have not materially changed. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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 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)

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 13, 2007	By: /s/ Charles L. McNew Charles L. McNew President & Chief Executive Officer (principal executive officer)
Date: February 13, 2007	By: /s/ Joseph Sciacca Joseph Sciacca Vice President, Finance & Chief Financial Officer (principal financial officer)