COMPLETE GENOMICS INC
Form 10-Q
May 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from ______ to ______

Commission file number: 001-34939

Complete Genomics, Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**20-3226545**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
2071 Stierlin Court Mountain View, California	**94043**
(Address of Principal Executive Offices)	**(Zip Code)**

(650) 943-2800

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of April 29, 2011, the number of outstanding shares of the registrant s common stock, par value $0.001 per share, was 26,011,321.

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COMPLETE GENOMICS, INC.

FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2011

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PART I FINANCIAL INFORMATION

COMPLETE GENOMICS, INC.

CONDENSED BALANCE SHEETS

(UNAUDITED)

	March 31, 2011	December 31, 2010
	(in thousands, except par value and share data)	
Assets		
Current assets		
Cash and cash equivalents	$ 68,791	$ 68,918
Accounts receivable	7,385	4,943
Inventory	3,176	3,980
Prepaid expenses	770	1,101
Other current assets	54	78
Total current assets	80,176	79,020
Property and equipment, net	24,256	23,843
Other assets	657	297
Total assets	$ 105,089	$ 103,160
Liabilities, Convertible Preferred Stock and Stockholders Equity		
Current liabilities		
Accounts payable	$ 3,256	$ 3,066
Accrued liabilities	3,788	3,102
Notes payable, current	1,412	5,780
Deferred revenue	7,021	5,739
Total current liabilities	15,477	17,687
Notes payable, net of current	22,724	7,521
Deferred rent, net of current	4,132	4,316
Total liabilities	42,333	29,524
Commitments and contingencies (Note 6)		
Preferred stock, par value $0.001 5,000,000 shares authorized and no shares outstanding at March 31, 2011 and December 31, 2010		
Stockholders equity		
Common stock, $0.001 par value 300,000,000 shares authorized and 25,988,934 shares issued and outstanding at March 31, 2011; 300,000,000 shares authorized and 25,922,627 shares issued and outstanding at December 31, 2010	26	26
Additional paid-in capital	214,039	212,458
Accumulated deficit	(151,309)	(138,848)
Total stockholders equity	62,756	73,636
Total liabilities, convertible preferred stock and stockholders equity	$ 105,089	$ 103,160

See accompanying notes to condensed financial statements.

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COMPLETE GENOMICS, INC.

CONDENSED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three months ended March 31, 2011	Three months ended March 31, 2010
	(in thousands, except share and per share data)	
Revenue	$ 6,833	$ 336
Costs and expenses:		
Cost of revenues	6,582	
Start-up production costs		4,077
Research and development	6,808	6,169
General and administrative	2,780	3,099
Sales and marketing	2,700	1,226
Total costs and expenses	18,870	14,571
Loss from operations	(12,037)	(14,235)
Interest expense	(340)	(311)
Interest and other income (expense), net	(84)	210
Net loss	$ (12,461)	$ (14,336)
Net loss per share attributed to common stockholders basic and diluted	$ (0.48)	$ (51.15)
Weighted-average shares of common stock outstanding used in computing net loss per share attributed to common stockholders basic and diluted	25,959,929	280,283

See accompanying notes to condensed financial statements.

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COMPLETE GENOMICS, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Three months ended March 31, 2011	2010
Cash flows from operating activities		
Net loss	$ (12,461)	$ (14,336)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,544	1,309
Amortization of debt issuance costs		65
Issuance of common stock to founders		1,840
Increase in inventory reserves	32	
Change in fair value of warrant liability	96	(209)
Stock-based compensation	494	540
Noncash interest expense related to notes payable	27	43
Loss on the disposal of property and equipment	7	33
Changes in assets and liabilities		
Accounts receivable	(2,442)	(72)
Inventory	772	(364)
Prepaid expenses	331	4,616
Other current assets	24	63
Other assets	(110)	28
Accounts payable	96	401
Accrued liabilities	590	500
Deferred revenue	1,282	1,484
Deferred rent	(184)	(166)
Net cash used in operating activities	(8,902)	(4,225)
Cash flows from investing activities		
Purchase of property and equipment	(2,870)	(10,172)
Purchase of patent	(250)	
Net cash used in investing activities	(3,120)	(10,172)
Cash flows from financing activities		
Proceeds from notes payable	20,000	
Repayment of notes payable	(8,205)	(1,065)
Proceeds from issuance of convertible preferred stock, net of issuance costs		10,060
Exercise of stock options	100	8
Net cash provided by financing activities	11,895	9,003
Net decrease in cash and cash equivalents	(127)	(5,394)
Cash and cash equivalents at beginning of period	68,918	7,765
Cash and cash equivalents at end of period	$ 68,791	$ 2,371

Supplemental disclosure of cash flow information

Cash paid for interest	$	315	$	199
Supplemental disclosure of noncash investing and financing activities				
Issuance of warrants for common stock in connection with term debt	$	987	$	
Acquisition of property and equipment under accounts payable	$	94	$	1,440

See accompanying notes to condensed financial statements.

Complete Genomics, Inc.

Notes to Financial Statements (unaudited)

1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Complete Genomics, Inc. (the Company) is a human genome sequencing company that has developed and commercialized a DNA sequencing platform for complete human genome sequencing and analysis. The Company s Complete Genomics Analysis Platform (CGA Platform) combines its proprietary human sequencing technology with its advanced informatics and data management software and its end-to-end outsourced service model to provide customers with data that is immediately ready to be used for genome-based research. The Company s solution provides academic and biopharmaceutical researchers with complete human genomic data and analysis without requiring them to invest in in-house sequencing instruments, high-performance computing resources and specialized personnel. In the DNA sequencing industry, complete human genome sequencing is generally deemed to be coverage of at least 90% of the nucleotides in the genome. The Company was incorporated in Delaware on June 14, 2005 and began operations in March 2006. Since inception, the Company has been engaged in developing its complete human genome sequencing technology, raising capital and recruiting personnel. In May 2010, the Company commenced full commercial operations.

These financial statements are prepared on a going concern basis that contemplates the realization of assets and discharge of liabilities in their normal course of business. The Company has incurred net operating losses and negative cash flows from operations during every year since inception. At March 31, 2011, the Company had an accumulated deficit of $151.3 million. Operating losses and negative cash flows may continue for the foreseeable future so failure to generate sufficient revenues, raise additional funds through public or private financings, or other arrangements, or reduce certain discretionary spending could have a material adverse effect on the Company s ability to achieve its intended business objectives. There can be no assurance that such additional financings, if needed, will be available on terms attractive to the Company, if at all. The Company s failure to raise capital when needed could have a material adverse effect on its business, financial condition and operating results. If additional funds are raised through the issuance of equity securities, the percentage ownership of the Company s then-current, stockholders would be reduced. Furthermore, such equity securities may have rights, preferences or privileges senior to those of the Company s currently outstanding common stock.

Basis of Presentation

The interim condensed financial statements have been prepared and presented by the Company in accordance with accounting principles generally accepted in the United States (GAAP) and the rules and regulations of the Securities and Exchange Commission, without audit, and reflect all adjustments necessary to present fairly the Company s interim financial information. The accounting principles and methods of computation adopted in these financial statements are the same as those of the audited financial statements for the year ended December 31, 2010.

The preparation of the Company s unaudited condensed financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the unaudited condensed financial statements and the reported amounts of expenses during the reporting period. Significant estimates include assumptions made in the liability for warrants to purchase common stock and stock-based compensation. Actual results could differ from those estimates.

Certain information and footnote disclosures normally included in the Company s annual financial statements prepared in accordance with GAAP have been condensed or omitted. The accompanying unaudited financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2010 included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2011. The financial results for any interim period are not necessarily indicative of financial results for the full year or any other interim period.

The Company operates in one segment, providing complete human genome sequencing and analysis.

Summary of Significant Accounting Policies

There have been no changes to the Company s significant accounting policies during the three months ended March 31, 2011 as compared to the significant accounting policies described in its audited financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

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2. CONCENTRATION OF CREDIT RISKS AND OTHER RISKS AND UNCERTAINTIES

The Company is subject to all of the risks inherent in an early-stage company developing a new approach to DNA sequencing. These risks include, but are not limited to, significant capital requirements, limited management resources, intense competition, dependence upon customer acceptance of the products in development and the changing nature of the DNA sequencing industry. The Company s operating results may be materially affected by the foregoing factors.

The Company depends on a limited number of suppliers, including single-source suppliers, of various critical components in the sequencing process. The loss of these suppliers, or their failure to supply the Company with the necessary components on a timely basis, could cause delays in the sequencing process and adversely affect the Company.

The Company derives accounts receivable from direct sales and amounts contractually due, but not received, under contracts. The Company reviews its exposure to accounts receivable and generally requires no collateral for any of its accounts receivable. The allowance for doubtful accounts is the Company s best estimate of the amount of expected credit losses existing in accounts receivable and is based upon specific customer issues that have been identified. As of March 31, 2011 and December 31, 2010, the Company has not recorded any allowance for doubtful accounts.

The Company allocates its revenues to individual countries based on the primary locations of its customers.

As of March 31, 2011 and December 31, 2010, customers representing greater than 10% of accounts receivable were as follows:

Customer	**March 31, 2011**	**December 31, 2010**
Customer F	25%	27%
Customer G	*	16%
Customer D	17%	*
Customer E	18%	*

* *Less than 10%*

For the three months ended March 31, 2011 and 2010, customers representing greater than 10% of revenue were as follows:

Customer	**Three months ended March 31, 2011**	**Three months ended March 31, 2010**
Customer A	*	30%
Customer B	*	30%
Customer C	*	30%
Customer D	34%	*
Customer E	18%	*

* *Less than 10%*

For the three months ended March 31, 2011 and 2010, countries representing greater than 10% of revenue were as follows:

Country	**Three months ended March 31, 2011**	**Three months ended March 31, 2010**
United States	70%	70%

Canada	*	30%
The Netherlands	24%	*
Other	*	*

* *Less than 10%*

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3. NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss attributed to common stockholders by the weighted-average number of common shares outstanding during the period. The Company s potential dilutive shares, which include outstanding common stock options and restricted stock units, convertible preferred stock and warrants, have not been included in the computation of diluted net loss per share for all periods as the result would be anti-dilutive. Such potentially dilutive shares are excluded when the effect would be to reduce the net loss per share.

The following outstanding shares of potentially dilutive securities were excluded from the computation of diluted net loss per share for the periods presented because including them would have had an anti-dilutive effect:

	March 31,	
	2011	**2010**
Options to purchase common stock	2,875,125	2,430,287
Restricted stock units for common stock	27,500	
Warrants to purchase convertible preferred stock		384,153
Warrants to purchase common stock	2,165,323	1,630,629
Convertible preferred stock (on an as-if converted basis)		10,533,490
Total	5,067,948	14,978,559

4. FAIR VALUE MEASUREMENT

Assets and liabilities recorded at fair value in the financial statements are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels which are directly related to the amount of subjectivity associated with the inputs to the valuation of these assets or liabilities are as follows:

Level 1: Observable inputs, such as quoted prices in active markets for identical assets or liabilities.

Level 2: Observable inputs, other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following tables set forth the Company s financial instruments that are measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010 and by level within the fair value hierarchy. Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires management to make judgments and consider factors specific to the asset or liability.

As of March 31, 2011, the Company s fair value hierarchy for its financial assets and financial liabilities that are carried at fair value was as follows:

	Level 1	Level 2	Level 3	Total
		(in thousands)		
Assets				
Money market fund (included in Cash and cash equivalents)	$ 40,634	$	$	$ 40,634
Liabilities				
Warrants to purchase common stock (included in accrued liabilities)	$	$	$ 378	$ 378

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As of December 31, 2010, the Company s fair value hierarchy for its financial assets and financial liabilities that are carried at fair value was as follows:

	Level 1	Level 2	Level 3	Total
		(in thousands)		
Assets				
Money market fund (included in cash and cash equivalents)	$ 50,623	$	$	$ 50,623
Liabilities				
Warrants to purchase common stock (included in accrued liabilities)	$	$	$ 282	$ 282

The Company valued its warrant liabilities using the Black-Scholes option pricing model. The expected term for these warrants is based on the remaining contractual life of these warrants. The expected volatility assumption was determined by examining the historical volatility for industry peers, as the Company did not have a sufficient trading history for its common stock. The risk-free interest rate assumption is based on U.S. Treasury investments whose term is consistent with the expected term of the warrants and purchase rights. The expected dividend assumption is based on the Company s history and expectation of dividend payouts.

The change in the fair value of the common stock warrant liability is summarized below:

	(in thousands)
Fair value at December 31, 2010	$ 282
Increase in the fair value recorded in interest and other income (expense), net	96
Fair value at March 31, 2011	$ 378

5. BALANCE SHEET COMPONENTS

Inventory

Inventory consists of the following:

	March 31, 2011	December 31, 2010
	(in thousands)	
Raw materials	$ 944	$ 1,426
Work-in-progress	1,559	1,917
Finished goods	673	637
	$ 3,176	$ 3,980

Property and Equipment, Net

Property and equipment, net, consist of the following:

	March 31, 2011	December 31, 2010
	(in thousands)	
Computer equipment	$ 7,688	$ 7,519

Computer software	1,863	1,857
Furniture and fixtures	354	354
Machinery and equipment	20,402	19,362
Leasehold improvements	7,301	7,024
Equipment under construction	1,502	37
	39,110	36,153
Less: Accumulated depreciation and amortization	(14,854)	(12,310)
	$ 24,256	$ 23,843

Depreciation and amortization expense for the three months ended March 31, 2011 and 2010 was $2.5 million and $1.3 million, respectively.

Accrued Liabilities

Accrued liabilities consist of the following:

	March 31, 2011	December 31, 2010
	(in thousands)	
Accrued compensation and benefits	$ 2,164	$ 1,934
Warrants to purchase common stock	378	282
Deferred rent, current	719	702
Other	527	184
	$ 3,788	$ 3,102

Intangible Assets, Net

In March 2006, the Company entered into an intellectual property agreement with Callida Genomics, Inc. for licenses related to the Company s core technology. Under the agreement, the Company has made annual payments of $250,000 for a duration of six years beginning in March 2006. Prior to March 2011, the payments are recorded in research and development expense. In 2011, the Company exited the development stage. Accordingly, the $250,000 licensing payment made in March 2011 is recorded as intangible assets in Other Assets. The intangible assets have an estimated useful life of five years and as of March 31, 2011, there was no accumulated amortization recorded.

6. COMMITMENTS AND CONTINGENCIES

Oxford Loan Agreement

On March 25, 2011, the Company entered into a loan and security agreement (the Oxford Loan and Security Agreement) with Oxford Finance Corporation (Oxford). The Oxford Loan Agreement provides for a term loan of $20.0 million. The outstanding balance of the term loan must be repaid in full by October 1, 2014 (the Maturity Date). Under the terms of the Oxford Loan Agreement, the outstanding balance accrues interest at a rate of 9.80% per annum. Until May 1, 2012 (the Amortization Date), the Company is required to make monthly payments equal to the accrued interest on the outstanding loan balance, and, following the Amortization Date through the Maturity Date the outstanding loan balance will be repaid in thirty (30) equal monthly payments of principal and interest.

As a condition to the Oxford Loan Agreement, a portion of the term loan was used to repay the remaining balance of $7.4 million on the Company s existing loan agreement with Comerica. Following repayment of the outstanding indebtedness, the Loan and Security Agreement with Comerica was terminated. The remainder of the term loan will be used to fund the Company s working capital requirements.

The term loan is secured by a senior priority on all of the Company s assets, excluding the Company s intellectual property and those assets securing borrowings under the Loan and Security Agreement with Atel (the Atel Loan Agreement). In addition, the Company has agreed not to pledge its intellectual property to another entity without Oxford s approval or consent.

In connection with the entry into the Oxford Loan Agreement, the Company issued to Oxford warrants to purchase an aggregate of 160,128 shares of common stock at an exercise price of $7.495 per share (Note 7). The warrants expire on the seventh anniversary of the issuance date. The Company also agreed to provide Oxford certain registration rights covering the warrants.

The Oxford Loan Agreement contains customary representations and warranties, covenants, closing and advancing conditions, events of defaults and termination provisions by, among and for the benefit of the parties. The affirmative covenants include, among other things, that the Company timely file taxes, maintain certain operating accounts subject to control agreements in favor of Oxford, maintain liability and other insurance, and pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case, without the prior consent of Oxford. The Oxford Loan Agreement provides that an event of default will occur if (1) there is a material adverse change in the Company s business, operations or condition (financial or otherwise), (2) there is a material impairment in the prospects of the Company repaying any portion of its obligations under the term loan, (3) there is a material impairment in the value of the collateral pledged to secure the Company s obligations under the agreement or in Oxford s perfection or priority over the collateral, (4) the Company defaults in the payment of any amount payable under the agreement when due, or (5) the Company breaches any negative covenant or certain affirmative covenants in the agreement (subject to a grace period in some cases). The repayment of the term loan is accelerated following the occurrence of an event of default or otherwise, requiring the Company to immediately pay to Oxford an amount equal to the sum of: (i) all outstanding principal plus accrued but unpaid interest, (ii) the prepayment fee, (iii) the final payment, plus (iv) all other sums, that shall have become due and payable but have not been paid, including interest at the default rate with respect to any past due amounts. As of March 31, 2011, the Company was in compliance with all the covenants.

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The Company paid to Oxford an aggregate of approximately $100,000 in commitment fees in connection with the Oxford Loan Agreement. In connection with the entry into the Oxford Loan Agreement, the Company and Atel amended the Atel Loan Agreement for certain technical and administrative amendments.

Atel Loan Agreement

The Atel Loan Agreement consists of a $6.0 million term loan for equipment purchases. Under the terms of the Atel Loan Agreement, the term loan balance is being repaid in 36 equal monthly payments of principal and interest. Interest accrues on the term loan at a rate of 11.26% per annum. The outstanding borrowings under the term loan are collateralized by a senior priority interest in certain of the Company s current property and equipment, and all property and equipment that is purchased during the term of the Atel Loan Agreement.

In connection with the Atel Loan Agreement, the Company issued to Atel a warrant to purchase 49,834 shares of the Company s common stock at an exercise price of $7.224 per share, as discussed in Note 7.

The Atel Loan Agreement contains customary representations and warranties, covenants, closing and advancing conditions, events of defaults and termination provisions by, among and for the benefit of the parties. The affirmative covenants include, among other things, that the Company maintain liability and other insurance and pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case, without the prior consent of Atel. As of March 31, 2011, the Company was in compliance with all the covenants.

Legal Proceedings

On August 3, 2010, a patent infringement lawsuit was filed by Illumina, Inc. and Solexa, Inc. (an entity acquired by Illumina), or the plaintiffs, against the Company in the U.S District Court in Delaware. The case caption is *Illumina, Inc. and Solexa, Inc. v. Complete Genomics, Inc.*, Civil Action No. 10-649. The complaint alleges that Complete Genomics Analysis Platform, and in particular the combinatorial probe anchor ligation technology, infringes upon three patents held by Illumina and Solexa. The plaintiffs seek unspecified monetary damages and injunctive relief. If the Company is found to infringe one or more valid claims of a patent-in-suit and if the district court grants an injunction, the Company may be forced to redesign portions of our sequencing process, seek a license or cease the infringing activity. On September 23, 2010, the Company filed an answer to the complaint as well as its counterclaims against the plaintiffs. On November 9, 2010, the U.S. District Court in Delaware granted the Company s motion to transfer the case to the Northern District of California. On May 5, 2011, the Court entered a stipulated order to dismiss two patents from the lawsuit. The dismissal is without prejudice but includes conditions on the ability to file lawsuits on these patents, including a limitation that Illumina may not re-file such lawsuits against the Company until the later of (1) August 1, 2012, or (2) the exhaustion of all appeal rights in both (a) the pending reexaminations in the U.S. Patent and Trademark Office and (b) the pending civil litigation in which these patents are also asserted, *Life Technologies Corp. v. Illumina*, Case No. 11-CV703 (S.D. Cal.). The Company believes that it has substantial and meritorious defenses to the plaintiffs claims and intend to vigorously defend its position. However, a negative outcome in this matter could have a material adverse effect on the Company s financial position, results of operations, cash flows and business. The Company is not currently able to estimate the potential loss, if any, that may result from this litigation.

From time to time, the Company may become involved in other legal proceedings and claims arising in the ordinary course of its business. Other than as described above, the Company is not currently a party to any legal proceedings the outcome of which, if determined adversely to the Company, would individually or in the aggregate have a material adverse effect on its business, operating results, financial condition or cash flows.

7. WARRANTS FOR COMMON STOCK

In March 2011, the Company issued a warrant to purchase 160,128 shares of common stock at an exercise price of $7.495 per share in connection with the Oxford Loan Agreement. The warrant expires on the seventh anniversary of its issuance date. The initial fair value of the warrant was calculated using the Black-Scholes option pricing model with the following assumptions: seven year contractual term; 75.01% volatility; 0% dividend rate; and a risk-free interest rate of 2.87%. The fair value of the warrant was determined to be $987,000 and was recorded as equity in additional paid-in capital and a discount to the carrying value of the loan.

The discount is being amortized to interest expense using the effective interest rate method over the 42-month term of the loan.

In December 2010, the Company issued a warrant to purchase 49,834 shares of common stock at an exercise price of $7.224 per share in connection with the Atel Loan Agreement. The warrant expires on the tenth anniversary of its issuance date. The initial fair value of the warrant was calculated using the Black-Scholes option pricing model with the following assumptions: 10 year contractual term; 76.2% volatility; 0% dividend rate; and a risk-free interest rate of 3.33%. The fair value of the warrant was determined to be $282,000 and was recorded as liability and a discount to the carrying value of the loan. The fair value of the warrant was recorded as a liability due to certain mandatory redemption features at the option of the holder. The discount is being amortized to interest expense using the effective interest rate method over the three-year term of the loan. These warrants will be marked to market each reporting period and the fair value will be impacted in part by the change in the Company s stock price, among other factors.

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8. STOCK-BASED COMPENSATION

Stock-based Compensation Plans

The number of shares reserved for issuance under the 2010 Equity Incentive Award Plan (the 2010 Plan) and the Employee Stock Purchase Plan (the ESPP) increased by 1,036,905 shares and 518,452 shares, respectively, effective January 1, 2011. As of March 31, 2011, there were 3,938,944 and 1,268,452 shares available to be granted under the 2010 Plan and the ESPP, respectively.

Compensation Expense

During the three months ended March 31, 2011 and 2010, the Company granted stock options to employees to purchase common stock as follows:

	Three Months Ended March 31,	
	2011	2010
	(in thousands, except share and per share amounts)	
Number of options granted to employees	103,700	915,189
Weighted-average grant date fair value per share of options granted to employees	$ 4.99	$ 1.70
Total fair value of options granted to employees which vested	$ 309	$ 177

During the three months ended March 31, 2011 and 2010, the Company did not grant any options to nonemployees nor did it grant any restricted stock units.

The following table summarizes the stock-based compensation expense from stock option and restricted stock unit awards to employees and nonemployees:

	Three Months Ended March 31,	
	2011	2010
	(in thousands)	
Employee awards	$ 473	$ 476
Nonemployee awards	21	64
Total compensation expense	**$ 494**	**$ 540**

As of March 31, 2011, the Company had unrecognized stock-based compensation expense related to unvested stock options and restricted stock units granted to employees of $3.9 million, which is expected to be recognized over the remaining weighted-average vesting period of 2.8 years.

9. SUBSEQUENT EVENTS

On May 5, 2011, the Company s Board of Directors approved the filing of a Registration Statement on Form S-1 with the Securities and Exchange Commission.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, a amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), which are subject to the safe harbor created by those sections. Forward-looking statements are based on our management s beliefs and assumptions and on information currently available to our management. All statements other than statements of historical factors are forward-looking statements for purposes of these provisions. In some cases you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, project, predict, and potential, and similar expressions intended to identify forward-looking statements. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors in this report. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a life sciences company that has developed and commercialized a DNA sequencing platform for complete human genome sequencing and analysis, and our goal is to become the preferred solution for complete human genome sequencing and analysis. Our Complete Genomics Analysis Platform, or CGA Platform, combines our proprietary human genome sequencing technology with our advanced informatics and data management software and our innovative, end-to-end, outsourced service model to provide our customers with data that is immediately ready to be used for genome-based research. We believe that our solution provides academic and biopharmaceutical researchers with complete human genomic data and analysis at an unprecedented combination of quality, cost and scale without requiring them to invest in in-house sequencing instruments, high-performance computing resources and specialized personnel. By removing these constraints and broadly enabling researchers to conduct large-scale complete human genome studies, we believe that our solution has the potential to significantly advance medical research and expand understanding of the basis, treatment and prevention of complex diseases.

We have targeted our complete human genome sequencing service at academic, governmental and other research institutions, as well as pharmaceutical and other life science companies. In the DNA sequencing industry, complete human genome sequencing is generally deemed to be coverage of at least 90% of the nucleotides in the genome. We perform our sequencing service at our Mountain View, California headquarters facility, which began commercial operation in May 2010. In the near term, we expect to make significant expenditures related to the expansion of our Mountain View sequencing facility and our research and development initiatives, as well as to increase our sales and marketing and general and administrative expenses to support our commercial operations and anticipated growth. In future years, we may construct additional genome centers in the United States and in other strategic markets to accommodate an expected growing, global demand for high-quality, low-cost complete human genome sequencing on a large scale.

Our ability to generate revenue, and the timing of our revenue, will depend on generating new orders and contracts, receiving qualified DNA samples from customers and the rate at which we can convert our backlog of sequencing orders into completed and delivered data and the price per genome contracted with the customer. We define backlog as the number of genomes for which customers have placed orders that we believe are firm and for which no revenue has yet been recorded. As of March 31, 2011, we had a backlog of orders for sequencing over 2,000 genomes which we believe could result in approximately $15.0 million in revenue over the next 12 months. The speed with which we can convert orders into revenue depends principally on:

- the speed with which our customers provide us with qualified samples after submitting an order;
- the rate at which our system can sequence a genome; and
- the rate at which all significant contractual obligations are fulfilled.

The presence or absence in a specific quarter of one or more new large orders for hundreds of genomes combined with our uncertain sales cycle and changes in the variables that influence conversion of orders to revenue will cause our results of operations and our backlog to fluctuate on a quarterly basis, perhaps significantly from one quarter to the next. In addition, we have only recently engaged in commercial-scale manufacturing, so we have a very limited history on which we can rely in making predictions regarding operating variables such as equipment failure, throughput yield, customer delivery of qualified genomic samples and other factors that could affect our ability to sequence genomes and recognize revenue.

We have not been profitable in any quarterly period since we were formed. We incurred net losses attributable to stockholders of $12.5 million and $14.3 million for the three months ended March 31, 2011 and 2010, respectively. For the three months ended March 31, 2011 and 2010, we recognized revenue of $6.8 million and $0.3 million, respectively. As of March 31, 2011, we had an accumulated deficit of $151.3 million.

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Although we do not anticipate any material seasonal effects, given our limited operating history as a revenue generating company, our sales cycle is uncertain. A limited number of customers accounted for all of the revenue we recognized for the three months ended March 31, 2011, with Pfizer and the University of Amsterdam accounting for approximately 34% and 18%, respectively, of this revenue. If demand for our services expands as expected, we do not anticipate that the loss of any of the customers named above would have a material adverse effect on our future results of operations.

Critical Accounting Policies and Estimates

Our management s discussion and analysis of our financial condition and results of operations are based on our unaudited financial statements that have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires our management to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the applicable periods. Management bases its estimates, assumptions and judgments on historical experience and on various other factors that it believes to be reasonable under the circumstances. Different assumptions and judgments would change the estimates used in the preparation of our financial statements, which, in turn, could materially change the results from those reported. Our management evaluates its estimates, assumptions and judgments on an ongoing basis. Historically, our critical accounting estimates have not differed materially from actual results. However, if our assumptions change, we may need to revise our estimates, or take other corrective actions, either of which may also have a material adverse effect on our statements of operations, liquidity and financial condition.

There have been no significant changes in critical accounting policies during the three months ended March 31, 2011, as compared to the critical accounting policies described in *Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates* in our Annual Report on Form 10-K for the year ended December 31, 2010.

Results of Operations

During the three months ended March 31, 2010 we had not yet achieved full commercial production. Revenue during this period was derived from genomic samples that were sequenced on our prototype production instruments. In addition, a substantial number of our research and development employees operated in production capacities while we continued to develop and refine our commercial genome sequencing process and validate our prototype instruments in anticipation of full commercial production. As a result, the costs that we incurred related to the sequencing of genomic samples during this period have been included in start-up production costs in the statement of operations.

By 2011 we achieved full commercial production as the development of the commercial genome sequencing process was completed and employees were dedicated to the production process. Therefore, the costs we incurred sequencing genomic samples during the three months ended March 31, 2011 are included in cost of revenue in the statement of operations.

Start-up production costs and cost of revenue include the costs related to acceptance testing of customer genomic samples, sample preparation and sequencing, the processing of data generated by our sequencing instruments and delivery of data to our customers.

Comparison of Three Months Ended March 31, 2011 and 2010

The following table shows the amounts of the listed items from our statements of operations for the periods presented, showing period-over-period changes (in thousands, except for percentages).

	Three months ended March 31,		First Quarter 2011 vs. First Quarter 2010	
	2011	**2010**	**$ Change**	**% Change**
	(unaudited)			
Revenue	$ 6,833	$ 336	$ 6,497	1,934%
Costs and expenses:				
Costs of revenue	6,582		(6,582)	*
Start-up production costs		4,077	4,077	*
Research and development	6,808	6,169	(639)	(10)%
General and administrative	2,780	3,099	319	10%
Sales and marketing	2,700	1,226	(1,474)	(120)%

Total costs and expenses	18,870	14,571	(4,299)	(30)%
Loss from operations	(12,037)	(14,235)	2,198	15%
Interest expense	(340)	(311)	(29)	(9)%
Interest and other income (expense), net	(84)	210	(294)	(140)%
Net loss	$ (12,461)	$ (14,336)	$ 1,875	13%

* result is not meaningful

Revenue

During the three months ended March 31, 2011, we recognized $6.8 million of revenue, compared to $0.3 million during the same period in 2010. In the three months ended March 31, 2010, we generated limited revenue from small-scale pilot projects. The significant revenue increase in the three months ended March 31, 2011 as compared to the corresponding period in 2010 reflects an increase in sequencing orders resulting from our expanded marketing and sales activities, which have expanded our customer base over the last nine months.

The per-genome price of our sequencing service is based principally on the number of genomes to be sequenced in the arrangement, with price per genome decreasing as order size increases. We anticipate periodically reducing the price per genome for our service as the costs of sequencing decreases and competitive conditions change. Average price per genome decreased from the fourth quarter of 2010 to the first quarter of 2011. Current pricing of genome services starts at $9,500 per genome for small order sizes and ranges to between $5,000 to $7,500 per genome for orders in the hundreds of genomes.

Costs of Revenue

During the three months ended March 31, 2011, we incurred $6.6 million of costs to provide our genome sequencing service. The $6.6 million of cost of revenue primarily consisted of $2.0 million in salaries and benefits expense, $1.7 million in depreciation expense and $0.8 million in materials.

We anticipate that these costs as a percentage of revenue will fluctuate as we increase sequencing capacity and our capacity utilization changes, as the sequencing price we charge to our customers changes and as we continue to improve and automate our human genome sequencing processes. However, we anticipate that our total cost of revenue will increase in absolute dollars as we sequence additional genomes and our revenue grows.

Start-up Production Costs

During the three months ended March 31, 2010, we incurred $4.1 million of start-up production costs to support the development of our genome sequencing service. The $4.1 million of start-up production costs primarily consisted of $1.4 million in salaries and benefits expense and $0.7 million in depreciation expense.

Research and Development

Research and development expenses were $6.8 million during the three months ended March 31, 2011, compared to $6.2 million during the three months ended March 31, 2010, representing an increase of $0.6 million, or 10%. The increase in research and development expenses was primarily due to an increase in salaries and benefits expense of $0.5 million and an increase of $0.8 million in genome sequencing costs due to an increase in the number of genomes sequenced for research purposes. These increases were partially offset by a decrease in bonus expense of $0.4 million. The increase in salaries and benefits cost is a result of increased headcount and refocusing of certain research and development resources that had been directed to start-up production activities in prior quarters.

We expect to continue to invest in research and development activities as we seek to enhance our sequencing processes, components and systems to improve the yield and throughput and reduce the cost of our sequencing service. Consequently, we believe that in the near future, our research and development expenses will increase.

General and Administrative

General and administrative expenses were $2.8 million for the three months ended March 31, 2011, compared to $3.1 million for the three months ended March 31, 2010, representing a decrease of $0.3 million, or 10%. The decrease in general and administrative expenses was primarily due to a $0.9 million reduction in stock-based compensation expense related to equity grants to two founders in the three months ended March 31, 2010. Consulting fees also decreased by $0.2 million in the first quarter of 2011 when compared to the same period in 2010. These decreases were partially offset by increases in employee salaries and benefits and legal and accounting fees of $0.3 million each. The increase in salaries and benefits expense was primarily due to increased headcount to support operations as a public company. In addition, outside services expense for legal and accounting support increased primarily due to operating as a public company.

We expect that general and administrative expenses will increase for the remainder of 2011 as we operate as a public company in 2011.

Sales and Marketing

Sales and marketing expenses were $2.7 million during the three months ended March 31, 2011, compared to $1.2 million during the three months ended March 31, 2010, representing an increase of $1.5 million, or 120%. The increase in sales and marketing expenses is due primarily to an increase in employee salaries and benefits expense of $0.9 million, and an increase in consulting expense and seminar expense of $0.1 million each. The increase in expenses was primarily a result of the growth of our sales and marketing organization to support the increased sales activity and overall growth of the Company.

We expect that sales and marketing expenses will continue to increase for the remainder of 2011 as we increase our headcount for sales and marketing personnel to expand our customer base and to generate growth in terms of both complete human genomes ordered and revenues.

Interest Expense

During the three months ended March 31, 2011, we incurred interest expense of $340,000 compared to $311,000 during the three months ended March 31, 2010. The increase in interest expense of $29,000 between the two periods was primarily due to higher debt balances related to our loans.

Interest and Other Income (Expense), Net

Interest and other income (expense), net, for the three months ended March 31, 2011 was an expense of $0.1 million compared to income of $0.2 million for the three months ended March 31, 2010. The change between the two periods was primarily due to the change in the valuation of our warrant liability.

Liquidity and Capital Resources

Since our inception, we have generated operating losses in every quarter, resulting in an accumulated deficit of $151.3 million as of March 31, 2011. We have financed our operations to date primarily through private placements of preferred stock and promissory notes, borrowings under our credit facilities, proceeds from our initial public offering and term debt. As of March 31, 2011, we had working capital of $64.7 million, consisting of $80.2 million in current assets and $15.5 million in current liabilities. As of December 31, 2010, working capital was $61.3 million, consisting of $79.0 million in current assets and $17.7 million in current liabilities. Our cash is invested primarily in money market funds. Cash in excess of immediate operating requirements is invested in accordance with our investment policy, primarily with the goals of capital preservation and liquidity maintenance.

Cash Flows for the Three Months Ended March 31, 2011 and 2010

The following table summarizes our cash flows for the three months ended March 31, 2011 and 2010.

	Three months ended March 31,	
	2011	2010
	(in thousands)	
Net cash used in operating activities	$ (8,902)	$ (4,225)
Net cash used in investing activities	(3,120)	(10,172)
Net cash provided by financing activities	11,895	9,003
Net decrease in cash and cash equivalents	$ (127)	$ (5,394)

Operating Activities

Net cash used in operating activities was $8.9 million during the three months ended March 31, 2011 and consisted of a net loss of $12.5 million, offset by noncash items of $3.2 million and a net increase in operating assets and liabilities of $0.4 million. Noncash items for the three months ended March 31, 2011 consisted primarily of the change in valuation of our warrant liability of $0.1 million, depreciation expense of $2.5 million and stock-based compensation expense of $0.5 million. The significant items in the change in operating assets and liabilities include an increase in accounts receivable of $2.4 million partially offset by a decrease in prepaid expenses and inventory of $0.3 million and $0.8 million, respectively, and increases in deferred revenue and accounts payable of $1.3 million and $0.1 million, respectively. The increase in accounts receivable and deferred revenue were due to increased revenue and advance billing arrangements during the first three months of 2011. The increase in accounts payable was due to purchases and expenses incurred as a result of the growth of the Company during the first three months of 2011.

Net cash used in operating activities was $4.2 million during the three months ended March 31, 2010 and consisted of a net loss of $14.3 million, offset by noncash items of $3.6 million and a net increase in operating assets and liabilities of $6.5 million. Noncash items for the three months ended March 31, 2010 consisted primarily of depreciation expense of $1.3 million, noncash compensation expense related to stock grants to our founders and stock-based compensation expense of $1.8 million and $0.5 million, respectively. The significant changes in operating assets and liabilities include increases in prepaid expenses and deferred revenues of $4.6 million and $1.5 million, respectively, offset by a decrease in inventory of $0.4 million.

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Investing Activities

Net cash used in investing activities was $3.1 million and $10.2 million for the three months ended March 31, 2011 and 2010, respectively. The amounts related entirely to purchases of property and equipment and a patent. The purchases of property and equipment during the first three months of 2011 and 2010 were primarily for sequencing equipment used in production.

Financing Activities

Net cash provided by financing activities during the three months ended March 31, 2011 of $11.9 million consisted primarily of $20.0 million in proceeds from our term loan with Oxford. These proceeds were partially offset by repayments on term loans of $8.2 million.

Net cash provided by financing activities during the three months ended March 31, 2010 of $9.0 million consisted primarily of $10.1 million in net proceeds from the issuance and sale of Series D preferred stock. These proceeds were partially offset by repayment of notes payable of $1.1 million.

Operating and Capital Expenditure Requirements

To date, we have not achieved profitability on a quarterly or annual basis. We expect our cash expenditures to increase significantly in the short-term. We plan to fund our short-term liquidity requirements using cash on hand at March 31, 2011. Our principal short-term liquidity needs are:

- to fund our working capital for commercial operations, including personnel costs and other operating expense;
- to expand the sequencing and computing capacity in our Mountain View and Santa Clara leased facilities;
- to finance the further development of our sequencing technology and services;
- to finance sales and marketing activities; and
- to service our debt obligations.

The cost of expansion of our current sequencing and supporting computing capacity in our Mountain View and Santa Clara, California leased facilities California in 2011 is estimated to be approximately $20.0 million. In addition, as a public company we also incur significant legal, accounting and other expenses that we did not incur as a private company. We anticipate that we will continue to incur net losses for the foreseeable future as we continue to expand our business and build our infrastructure. We believe that, based on our current level of operations and anticipated growth, the net proceeds from our initial public offering, our cash and cash equivalent balances, including interest income we earn on those balances, will be sufficient to meet our anticipated cash requirements for the 12 months from the date of this filing.

In addition to our continued expenditures for the expansion of our Mountain View sequencing facility, further development of our sequencing technology and services, and expansion of our sales and marketing activities, our principal long-term liquidity needs are:

- to fund our working capital for commercial operations, including any growth in working capital required by growth in our business;
- to finance the possible development of additional sequencing centers; and

to service our debt obligations.

Our current cash resources are insufficient to satisfy our long term liquidity requirements. Based on our current operating projections, we will need to raise additional capital to fund our operations in 2012 and expand our business to meet our long-term business objectives. Additional financing, which is not in place at this time, may be from the sale of equity or convertible or other debt securities in a public or private offering, from an additional credit facility, or strategic partnership coupled with an investment in our company or a combination of both. If we raise additional funds through the issuance of convertible debt securities, or other debt securities, these securities could have rights senior to those of our common stock and could contain covenants that restrict our operations. The issuance of any equity securities will also dilute the interest of our current stockholders.

We may be unable to raise sufficient additional financing on terms that are acceptable, if at all. Given the risks associated with our business, including our limited operating history and our new business model in an emerging industry, and recent difficulties for life sciences companies raising funds in the capital markets, we cannot guarantee that we will be able to raise additional capital in the amounts we require, if at all. Our failure to raise additional capital and in sufficient amounts will severely impact our ability to operate our business in 2012 and meet our long-term business objectives. The timing and amount of our future capital requirements will depend on many factors, including, but not limited to, the following:

- the financial success of our genome sequencing business;

- our ability to increase the genome sequencing capacity in our Mountain View facility;

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whether we are successful in obtaining payments from customers;

whether we can enter into collaborations and establish a recurring customer base;

the progress and scope of our research and development projects;

the filing, prosecution and enforcement of patent claims;

the rate at which we establish possible additional genome sequencing centers and whether we can find suitable partners with which to establish those centers;

the effect of any joint ventures or acquisitions of other businesses or technologies that we may enter into or make in the future; and

the costs associated with lawsuits brought against us by third parties, including our current litigation with Illumina, Inc.

Our forecast of the period of time through which our financial resources will be adequate to support our operations and the costs to support our general and administrative, sales and marketing and research and development activities are forward-looking statements and involve risks and uncertainties. Actual results could vary materially and negatively as a result of a number of factors, including the factors discussed in our risk factors in Part II Item 1A below. We have based these estimates on assumptions that may prove to be wrong, and we could use our available capital resources sooner than we currently expect.

Term Loans

On December 17, 2010, we entered into a loan and security agreement with Atel Ventures, Inc. (Atel). On March 25, 2011, we entered into a new loan and security agreement with Oxford Finance Corporation (Oxford).

Atel Loan Agreement

The loan and security agreement with Atel (the Atel Loan Agreement) consists of a $6.0 million term loan for equipment purchases, which is collateralized to secure the term loan. Under the terms of the Atel Loan Agreement, the term loan balance is being repaid in 36 equal monthly payments of principal and interest. Interest accrues on the term loan at a rate of 11.26% per annum. The outstanding borrowings under the term loan are collateralized by a senior priority interest in certain of our current property and equipment, and all property and equipment that was purchased during the term of the Atel Loan Agreement. In connection with entering into the loan and security agreement with Oxford, we and Atel made certain administrative and technical amendments to the Atel Loan Agreement.

In connection with the Atel Loan Agreement, we issued to Atel a warrant to purchase 49,834 shares of our common stock at an exercise price of $7.224 per share. The Atel Warrant expires on the 10th anniversary of the issuance date.

The Atel Loan Agreement contains customary representations and warranties, covenants, including closing and advancing conditions, events of defaults and termination provisions. The affirmative covenants include, among other things, that we maintain certain cash account balances, and liability and other insurance, and that we pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude us from, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case without the prior consent of Atel. As of March 31, 2011, we were in compliance with all the covenants in the Atel Loan Agreement.

Oxford Loan Agreement

On March 25, 2011, we entered into a loan and security agreement (the Oxford Loan Agreement) with Oxford Finance Corporation (Oxford). The Oxford Loan Agreement provides for a term loan of $20.0 million. The outstanding balance of the term loan must be repaid in full by

October 1, 2014 (the Maturity Date). Under the terms of the Oxford Loan Agreement, the outstanding balance accrues interest at a rate of 9.80% per annum. Until May 1, 2012 (the Amortization Date), we must make monthly payments equal to the accrued interest on the outstanding loan balance, and, following the Amortization Date through the Maturity Date the outstanding loan balance will be repaid in thirty (30) equal monthly payments of principal and interest.

As a condition to the Oxford Loan Agreement, a portion of the term loan was used to repay the remaining balance of $7.4 million on our existing term loan agreement with Comerica. Following repayment of the outstanding indebtedness, the Comerica Loan Agreement was terminated. We intend to use the remainder of the Oxford term loan to fund our working capital requirements.

The term loan is secured by a senior priority on all of our assets, excluding our intellectual property and those assets securing borrowings under the Atel loan agreement. In addition, we have agreed not to pledge our intellectual property to another entity without Oxford s approval or consent.

In connection with the entry into the Oxford Loan Agreement, we issued to Oxford warrants to purchase an aggregate of 160,128 shares of our common stock (the Warrant Shares) at an exercise price of $7.495 per share. The warrants expire on the seventh anniversary of the issuance date. We also agreed to provide Oxford certain registration rights covering the Warrant Shares.

The Oxford Loan Agreement contains customary representations and warranties, covenants, closing and advancing conditions, events of defaults and termination provisions. The affirmative covenants include, among other things, that we timely file taxes, maintain certain operating accounts subject to control agreements in favor of Oxford, maintain liability and other insurance, and pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case, without the prior consent of Oxford. The Oxford Loan Agreement provides that an event of default will occur if (1) there is a material adverse change in our business, operations or condition (financial or otherwise), (2) there is a material impairment in the prospects of us repaying any portion of our obligations under the term loan, (3) there is a material impairment in the value of the collateral pledged to secure our obligations under the agreement or in Oxford s perfection or priority over the collateral, (4) we default in the payment of any amount payable under the agreement when due, or (5) we breach any negative covenant or certain affirmative covenants in the agreement (subject to a grace period in some cases). The repayment of the term loan is accelerated following the occurrence of an event of default or otherwise, which would require us to immediately pay an amount equal to the sum of: (i) all outstanding principal plus accrued but unpaid interest, (ii) the prepayment fee, (iii) the final payment, plus (iv) all other sums, that shall have become due and payable but have not been paid, including interest at the default rate with respect to any past due amounts. As of March 31, 2011, we were in compliance with all the covenants.

Contractual Obligations and Commitments

There have been no material changes to our contractual obligations as reported in our Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the Securities Exchange Commission on March 30, 2011.

Off-Balance Sheet Arrangements

We do not currently have, nor have we ever had, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

As of March 31, 2011, our investment portfolio consists of money market funds. The primary objectives of our investment are to preserve capital and maintain liquidity. Our primary exposures to market risk are interest rate income sensitivity, which is affected by changes in the general level of U.S. interest rates, and conditions in the credit markets, including default risk. However, since all of our investments are in money market funds, we do not believe we are subject to any material market interest rate risk exposure. We do not have any foreign currency or any other derivative financial instruments.

ITEM 4: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive and financial officers, evaluated the effectiveness of our disclosures controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of March 31, 2011. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2011, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended March 31, 2011 identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

On August 3, 2010, a patent infringement lawsuit was filed by Illumina, Inc. and Solexa, Inc. (an entity acquired by Illumina), or the plaintiffs, against us in the U.S District Court in Delaware. The case caption is *Illumina, Inc. and Solexa, Inc. v. Complete Genomics, Inc.*, Civil Action No. 10-649. The complaint alleges that our Complete Genomics Analysis Platform, and in particular our combinatorial probe anchor ligation technology, infringes upon three patents held by Illumina and Solexa. The plaintiffs seek unspecified monetary damages and injunctive relief. If we are found to infringe one or more valid claims of a patent-in-suit and if the district court grants an injunction, we may be forced to redesign portions of our sequencing process, seek a license or cease the infringing activity. On September 23, 2010, we filed our answer to the complaint as well as our counterclaims against the plaintiffs. On November 9, 2010, the U.S. District Court in Delaware granted our motion to transfer the case to the Northern District of California. On May 5, 2011, the Court entered a stipulated order to dismiss two patents from the lawsuit. The dismissal is without prejudice but includes conditions on the ability to file lawsuits on these patents, including a limitation that Illumina may not re-file such lawsuits against us until the later of (1) August 1, 2012, or (2) the exhaustion of all appeal rights in both (a) the pending reexaminations in the U.S. Patent and Trademark Office and (b) the pending civil litigation in which these patents are also asserted, *Life Technologies Corp. v. Illumina*, Case No. 11-CV703 (S.D. Cal.). We believe that we have substantial and meritorious defenses to the plaintiffs claims and intend to vigorously defend our position. However, a negative outcome in this matter could have a material adverse effect on our financial position, results of operations, cash flows and business. We are not currently able to estimate the potential loss, if any, that may result from this litigation.

From time to time, we may become involved in other legal proceedings and claims arising in the ordinary course of our business. Other than as described above, we are not currently a party to any legal proceedings the outcome of which, if determined adversely to us, we believe would individually or in the aggregate have a material adverse effect on our business, operating results, financial condition or cash flows.

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ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Annual Report on Form 10-Q. If any of such risks actually occur, our business, operating results or financial condition could be adversely affected. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment.

Risks Related to Our Limited Operating History, Financial Condition and Capital Requirements

We are an early, commercial-stage company and have a limited operating history, which may make it difficult to evaluate our current business and predict our future performance.

We are an early, commercial-stage company and have a limited operating history. We were incorporated in Delaware in June 2005 and began operations in March 2006. From March 2006 until mid-2009, our operations focused on research and development of our DNA sequencing technology platform. In December 2009, we recognized our first revenue from the sale of our genome sequencing services, and in 2010 and the three months ended March 31, 2011, our revenue was $9.4 million and $6.8 million, respectively. Our limited operating history, particularly in light of our novel, service-based business model in the rapidly evolving genome sequencing industry, may make it difficult to evaluate our current business and predict our future performance. Our lack of a long operating history, and especially our very short history as a revenue-generating company, make any assessment of our profitability or prediction about our future success or viability subject to significant uncertainty. We have encountered and will continue to encounter risks and difficulties frequently experienced by early, commercial-stage companies in rapidly evolving industries. If we do not address these risks successfully, our business will suffer.

Based on our current operating projections, we will need substantial additional capital in the future in order to maintain and expand our business. A failure to secure additional capital will have a material effect on our ability to meet our long-term objectives.

Our future capital requirements are substantial, particularly as we further develop our business, expand the sequencing and computing capacity in our Mountain View and Santa Clara, California leased facilities and establish additional genome sequencing centers. Historically, we have financed our operations through private placements of preferred stock, convertible debt, borrowings under our credit facility, secured debt and through our recently completed IPO.

We believe that, based on our current level of operations and anticipated growth, our cash and cash equivalent balances, including interest income we earn on those cash balances, will be sufficient to meet our anticipated cash requirements for the next 12 months from the date of filing. However, based on our current operating projections, we will need additional capital to fund our operations in 2012 and to expand our business to achieve our longer term business objectives.

We may not be able to raise sufficient additional financing on terms that are acceptable, if at all. Given the risks associated with our business, including our limited operating history and our new business model in an emerging industry, and recent difficulties for life sciences companies raising funds in the capital markets, we may be unable to raise additional capital in the amounts we require, if at all. Our failure to raise additional capital in sufficient amounts, will severely impact our ability to achieve our long-term business objectives. In addition, if future financings involve the issuance of equity securities, our existing stockholders would suffer dilution. If we raise additional debt financing, we may be subject to restrictive covenants that limit our ability to conduct our business. If we fail to raise sufficient funds and continue to incur losses, our ability to operate our business, take advantage of strategic opportunities, further develop and enhance our technology or otherwise respond to competitive pressures could significantly suffer. If this happens, we may be forced to:

- slow or halt the expansion of our Mountain View facility and the establishment of additional genome sequencing centers;
- slow the commercialization of our services;
- delay or terminate research or development programs;
- curtail or cease operations; or

- seek to obtain funds through collaborative and licensing arrangements, which may require us to relinquish commercial rights or grant licenses on terms that are not favorable to us.

The amount of additional capital and timing at which we require the additional capital necessary to fund our operations and expand our business depends on many factors, including:

- the financial success of our genome sequencing business;

- our ability to increase the sequencing and computing capacity in our Mountain View and Santa Clara leased facilities;

the rate at which we establish additional genome sequencing centers and whether we can find suitable partners to establish such centers, if at all;

whether we are successful in obtaining payments from customers;

whether we can enter into collaborations or establish a recurring customer base;

the progress and scope of our research and development projects;

the effect of any joint ventures or acquisitions of other businesses or technologies that we may enter into or make in the future;

the filing, prosecution and enforcement of patent claims; and

the costs associated with lawsuits brought against us by third parties, including our current litigation with Illumina, Inc.

We have a history of losses, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.

We have not been profitable in any quarterly period since we were formed. We incurred net losses of $28.4 million, $35.9 million and $57.7 million for the years ended December 31, 2008, 2009 and 2010, respectively. As of March 31, 2011, our accumulated deficit was $151.3 million. Based on our current operating plans and assumptions, we do not expect to achieve profitability on an annual basis in the near future. In addition, we expect our cash expenditures to increase significantly in the near term, including significant expenditures for the expansion of our Mountain View, California sequencing facility, research and development, sales and marketing and general and administrative expenses and the possible development of additional sequencing centers. We may encounter unforeseen difficulties, complications and delays in expanding our Mountain View sequencing facility or in establishing additional genome sequencing centers and other unforeseen factors that require additional expenditures. These costs, among other factors, have had and will continue to have an adverse effect on our working capital and stockholders equity. We will have to generate and sustain substantially increased revenue to achieve and maintain profitability, which we may never do. If we are unable to achieve and then maintain profitability, the market value of our common stock will decline.

Our operating results may fluctuate in the future. As a result, we may fail to meet or exceed the expectations of research analysts or investors, which could cause our stock price to decline.

Our financial condition and operating results may fluctuate from quarter to quarter and year to year in the future due to a variety of factors, many of which are beyond our control. Factors relating to our business that may contribute to these fluctuations include the following, as well as other factors described elsewhere in this Form 10-Q:

our ability to achieve profitability;

our need for and ability to obtain capital necessary to operate and expand our business;

the size and frequency of customer orders;

the presence or absence in a specific quarter of one or more new large orders for hundreds of genomes;

our ability to expand our sequencing operations;

the cost of our sequencing services;

the demand for the sequencing of complete human genomes;

the existence and extent of government funding for research and development relating to genome sequencing;

the emergence of alternative genome sequencing technologies;

risks associated with expanding our business into international markets;

our ability to lower the average cost per genome that we sequence;

our dependence on single-source suppliers;

our ability to manage our growth;

our ability to successfully partner with other businesses in joint ventures or collaborations, or integrate any businesses we may acquire with our business;

our dependence on, and the need to attract and retain, key management and qualified sales personnel;

our ability to obtain, protect and enforce our intellectual property rights and avoid infringing the intellectual property rights of others;

our ability to prevent the theft or misappropriation of our know-how or technologies;

lawsuits brought against us by third parties;

business interruptions, such as earthquakes and other natural disasters;

public concerns about the ethical, legal and social concerns related to the use of genetic information;

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- our ability to comply with current laws and regulations and new or expanded regulatory schemes;
- our ability to properly handle and dispose of hazardous materials used in our business and biological waste; and
- our ability to use our net operating loss carryforwards to offset future taxable income.

Due to the various factors mentioned above, and others, the results of any prior quarterly or annual periods are not necessarily indicative of our future operating performance.

Risks Related to Our Business

Our only source of revenue is our human genome sequencing service, which is a new business model in an emerging industry, and failure to achieve market acceptance will harm our business.

Since our inception, all of our efforts have been focused on the creation of a technology platform for our human genome sequencing service, which we have only just recently commercialized. We expect to generate all of our revenue from our human genome sequencing service for the foreseeable future. As a result, market acceptance of our human genome sequencing service is critical to our future success.

Providing genome sequencing as a service is a new and unproven business model in a relatively new and rapidly evolving industry. We are using proprietary technology, involving multiple scientific and engineering disciplines, and a novel service model to bring complete human genome sequencing to an unproven market. Historically, companies in this industry have sold sequencing instruments directly to customers, and the customer performs the sequencing itself. We do not know if the purchasers and users of sequencing instruments will adopt our service model. For example, many potential customers want to sequence human genomes for proprietary studies that may lead to discoveries which they would seek to exploit, either commercially or through the publication of scientific literature. Accordingly, these potential customers may have significant reservations about allowing a third party to control the sequencing processes for their proprietary studies. Alternatively, other potential customers may want to sequence only portions of human genomes, rather than complete human genomes. There are many reasons why our services might not become widely adopted, ranging from logistical or quality problems to a failure by our sales force to engage potential customers, and including the other reasons stated in this Risk Factors section. As a result, our genome sequencing service may not achieve sufficient market acceptance to allow us to become profitable.

Our success depends on the growth of markets for analysis of genetic variation and biological function, and the shift of these markets to complete human genome sequencing.

We are currently targeting customers for our genome sequencing service in academic and government research institutions and in the pharmaceutical and other life science industries. Our customers are using our service for small- and large-scale human genome studies for a wide variety of diagnostic and discovery applications. These markets are new and emerging, and they may not develop as quickly as we anticipate, or reach their full potential. The development of the market for complete human genome sequencing and the success of our service depend in part on the following factors:

- demand by researchers for complete human genome sequencing;
- the usefulness of genomic data in identifying or treating disease;
- the ability of our customers to successfully analyze the genomic data we provide;
- the ability of researchers to convert genomic data into medically valuable information;

- the capacity and scalability of the hardware storage components necessary to store, manage, backup, retain and safeguard genomic data; and

- the development of software tools to efficiently search, correlate and manage genomic data.

For instance, demand for our genome sequencing service may decrease if researchers fail to find meaningful correlations between genetic variation and disease susceptibility through genome-wide association studies. In addition, factors affecting research and development spending generally, such as changes in the regulatory environment affecting pharmaceutical and other life science companies and changes in government programs that provide funding to companies and research institutions, could harm our business. If our target markets do not develop in a timely manner, demand for our service may grow at a slower rate than we expect, or may fall, and we may not achieve profitability.

To date, relatively few complete human genomes have been sequenced, in large part due to the high cost of large-scale sequencing. Our business plan assumes that the demand for sequencing complete human genomes will increase significantly as the cost of complete human genome sequencing decreases. This assumption may prove to be incorrect, or the increase in demand may take significantly more time than we anticipate. For example, potential customers may not think our cost reductions are sufficient to permit or justify large-scale sequencing. Moreover, some companies and institutions have focused on sequencing targeted areas of the genome that are believed to be primarily associated with disorders and diseases, as opposed to the entire genome. Demand for sequencing complete human genomes may not increase if these targeted sequencing strategies, such as exome sequencing, where selected regions containing key portions of genes are sequenced, prove to be more cost effective or are viewed as a more efficient method of genetic analysis than complete human genome sequencing. Since exome sequencing is currently less expensive than the sequencing of an entire human genome, customers, including those with limited budgets, may choose to sequence exomes instead of using our human genome sequencing services.

We face significant competition. Our failure to compete effectively could adversely affect our sales and results of operations.

We currently compete with companies that develop, manufacture and market genome sequencing instruments or provide genome sequencing services. We expect competition to increase as our competitors develop new, improved or cheaper instruments or expand their businesses to include sequencing services, and as new companies enter the market with innovative technologies.

The market for genome sequencing technology is highly competitive and is served by several large companies with significant market shares. For example, established companies such as Illumina, Inc., Life Technologies Corporation and Roche Diagnostics Corporation are marketing instruments for genetic sequencing that are directly competitive with our services, and these companies have significantly greater financial, technical, marketing and other resources than we do to invest in new technologies and have substantial intellectual property portfolios and substantial experience in product development and regulatory expertise. Also, there are many other companies, such as NABsys, Inc., Oxford Nanopore Technologies, Ltd., and Pacific Biosciences, Inc., that are developing sequencing technologies or services that would compete with ours. Moreover, large established companies may acquire smaller companies with emerging technologies and use their extensive resources to develop and commercialize such technologies or incorporate such technologies into their instruments and services. For example, in 2010, Life Technologies acquired Ion Torrent Systems, Inc., a chip-based sequencing technology company.

In addition, there are many research, academic and other non-profit institutions that are pursuing new sequencing technologies. These institutions often have access to significant government and other funding. For example, BGI (formerly known as Beijing Genomics Institute) in the People s Republic of China offers a service that is similar to ours and is funded by the government of China. In the United States, agencies such as the National Human Genome Research Institute provide funding to institutions to discover new sequencing technology. We may compete directly with these institutions, or these institutions may license their technologies to third parties with whom we would compete.

While many of our existing competitors primarily sell sequencing instruments, they may also provide sequencing services like us. Since these competitors have already developed their own sequencing technology, they will not experience significant technological barriers to entry and can likely enter the sequencing services market fairly quickly and with little additional cost. For example, Illumina started providing whole genome sequencing services in-house and through its Illumina Genome Network in mid-2010, and Life Technologies has recently announced a collaboration to build a genome sequencing facility. Furthermore, many of these instrumentation companies have already established a significant market presence and are trusted by customers in the industry. As established instrumentation companies enter the sequencing services market, many potential customers may purchase sequencing services from these companies instead of us, even if we offer superior technology and services.

The emergence of competitive genome sequencing technologies may harm our business.

The success of our genome sequencing services will depend, in part, on our ability to continue to enhance the performance and decrease the cost of our genome sequencing technology. A number of genome sequencing technologies exist, and new methods and improvement to existing methods are currently being developed, including technology platforms developed by companies that we expect will directly compete with us as providers of sequencing services or instruments. These new technologies may result in faster, more cost-effective and more accurate sequencing methods than ours. For example, our sequencing technology does not currently cover all of the nucleotides in the genome. If competitive technologies emerge that sequence portions of the genome that our technology does not, our business could suffer if those portions contain important genomic information. We expect to face competition from emerging companies, including NABsys, Oxford Nanopore Technologies and Pacific Biosciences. As a result of the emergence of these competitive sequencing technologies, demand for our service may decline or never develop sufficiently to sustain our operations.

Our industry is rapidly changing, with emerging and continually evolving technologies that increase the efficiency and reduce the cost of sequencing genomes. As new technologies emerge, we believe that the cost and error rates of, and the time required to, sequence human genomes will eventually decrease to a level where competition in the industry will shift to other factors, such as providing related services and analytical technologies. We may not be able to maintain any technological advantage over these new sequencing technologies, and if we fail to compete effectively on other factors relevant to our customers, our business will suffer.

Our order backlog may never be completed, and we may never earn revenue on backlogged contracts to sequence genomes.

As of March 31, 2011, we had a backlog of orders for sequencing over 2,000 genomes, which we believe could result in approximately $15.0 million in revenue over the next 12 months. This figure represents the number of genomes for which customers have placed sequencing orders that we believe are firm and for which we have not yet recognized revenue. We may not be able to convert order backlog into revenue at the rate or times we anticipate, or at all. Consequently, the order backlog we report in this Form 10-Q and elsewhere from time to time may not be indicative of future revenue.

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We may fail to complete backlog orders as we expect for many reasons. We may experience sequencing delays or customers might cancel orders. We are in the early stages of launching our services, and while we have been increasing our throughput capacity rapidly, we have in the past experienced growing backlog due to our inability to keep pace with new orders. Delays in sequencing for which we are responsible could cause backlog orders to be cancelled by customers, which has happened to us at least once. Even with sufficient throughput capacity, we are not always in control of the rate at which we complete orders and therefore convert backlog to revenue. For example, customers often place firm orders with us before providing us with genomic samples, delaying our start of the sequencing process by weeks or months. Additionally, once we receive a customer s samples, we test them to assure that they are of sufficient quality and quantity for sequencing. If not, we contact the customer and request additional samples, resulting in further delay. Also, customers may negotiate a period of time, measured in weeks or in some cases months, to accept or reject our sequencing reports once delivered. Customer acceptance in these instances is a prerequisite for recording revenue for those orders. For these reasons, you should use caution in adopting changes in, or the absolute amount of, our backlog as a proxy for market acceptance of our sequencing services or as an indicator of future revenue.

The presence or absence in a specific quarter of one or more new large orders, or the cancellation of any previous orders, for hundreds of genomes may cause our results of operations and backlog to fluctuate significantly on a quarterly basis.

Since beginning commercial operations, we have received purchase orders or contracts from a limited number of customers each quarter, typically between 10 and 20 customers quarterly. Historically, the size of each purchase order has fluctuated between a few genomes and multiple hundreds of genomes. As a result, the presence or absence in a specific quarter of one or more new large orders, or the cancellation of any previous orders, for hundreds of genomes. Combined with our uncertain sales cycle and changes in the variables that influence conversion of orders into revenue, may cause our results of operations and our backlog to fluctuate on a quarterly basis. These fluctuations may be significant from one quarter to the next. In addition, our limited commercial history and the characteristic of our quarterly orders makes it very difficult to predict or forecast our future operating results and backlog.

We must significantly increase our production capabilities in order to achieve profitability.

We have very limited experience in running a commercial-scale production facility. We have only one sequencing facility, which at present has the capacity to sequence over 400 complete human genomes per month. This capacity is significantly less than what would be required to achieve profitability. Our business plan assumes that we will be able to increase our capacity multiple fold.

We plan to increase the capacity of our sequencing facility by installing additional sequencing machines, improving our software and designing and installing newer generations of sequencing instruments that are currently under research and development. We may also construct additional genome sequencing centers in the United States and elsewhere in 2012 and afterward. We may encounter difficulties in expanding our sequencing infrastructure, and we may not build and improve this infrastructure in time to meet the volume, quality or timing requirements necessary to be successful. Manufacturing and supply quality issues may arise, including due to third parties who provide the components of our technology platform. Implementing improvements to our sequencing technology may involve significant changes, which may result in delays, or may not achieve expected results. For example, we are experimenting with increasing the density of DNBs on our DNA arrays. These experiments may be unsuccessful and may not lead to feasible technological improvements that increase the capacity or reduce the costs of our sequencing services. If capacity or cost limitations prevent us from meeting our customers expectations, we will lose revenue and our potential customers may take their business to our competitors.

Our need to increase capacity may require us to upgrade our machines to enhance our current production process. This may render our current machines obsolete sooner than anticipated. If this occurs, the value of these machines could be impaired and we may need to write down the value of this equipment, which could have a material impact on our financial statements in light of the dollar significance of the long-lived assets carried on our balance sheet.

Our genome sequencing technology platform was developed for human DNA and is not currently optimized to sequence non-human DNA.

Our technology platform was developed and has been optimized for sequencing human DNA, and we do not intend to sequence non-human DNA. We face significant competition from established companies who sell genome sequencing instruments that can sequence both human and non-human DNA. Many of the academic and research institutions that are our target customers conduct studies on both human and non-human DNA. Prospective customers may choose to purchase sequencing instruments from a competitor because of their broader sequencing application. Our competitors may also choose to provide sequencing services for non-human DNA. As a result, there may not be sufficient demand for our human genome sequencing service, which will harm our business.

We depend on a limited number of suppliers, including single-source suppliers, of various critical components for our sequencing process. The loss of these suppliers, or their failure to supply us with the necessary components on a timely basis, could cause delays in the current

and future capacity of our sequencing center and adversely affect our business.

We depend on a limited number of suppliers, including some single-source suppliers, of various critical components for our sequencing process. We do not have long-term contracts with our suppliers or service providers. Because we do not have long-term contracts, our suppliers generally are not required to provide us with any guaranteed minimum production levels. As a result, we may not be able to obtain sufficient quantities of critical components in the future.

Although alternative suppliers exist for each of the critical components of our sequencing process, that process has been designed around the functions, limitations, features and specifications of the components that we currently utilize. For example, the cameras in our sequencers are supplied by Hamamatsu Photonics and the optical equipment is supplied by Carl Zeiss, Inc. A failure by either or both of these companies to supply these components would require us to integrate alternative cameras and optical equipment, and potentially integrate other components, into future sequencing instruments. If we are required to integrate new components into future sequencers, we would experience a delay in the deployment of these sequencers, and, as a result, our efforts to expand our sequencing capacity would be delayed.

A delay or interruption by our suppliers may also harm our business. For example, the wafers that comprise the base of our sample slide are fabricated by SVTC Technologies, L.L.C. We have not yet qualified an alternative source for the supply of these wafers, which are critical to our sequencing process, and the custom manner in which these wafers are made may make it difficult to qualify other semiconductor suppliers to manufacture them for us. Similarly, an interruption of services by Amazon Web Services, on whom we rely to deliver finished genomic data to our customers, would result in our customers not receiving their data on time.

In addition, the lead time needed to establish a relationship with a new supplier can be lengthy, and we may experience delays in meeting demand in the event we must switch to a new supplier. The time and effort to qualify a new supplier could result in additional costs, diversion of resources or reduced manufacturing yields, any of which would negatively impact our operating results. Our dependence on single-source suppliers exposes us to numerous risks, including the following:

- our suppliers may cease or reduce production or deliveries, raise prices or renegotiate terms;
- delays by our suppliers could significantly limit our ability to sequence customer data and delay our efforts to increase our sequencing capacity;
- we may be unable to locate a suitable replacement on acceptable terms or on a timely basis, if at all; and
- delays caused by supply issues may harm our reputation, frustrate our customers and cause them to turn to our competitors for future projects.

If our Mountain View genome sequencing facility becomes inoperable, we will be unable to perform our genome sequencing services and our business will be harmed.

We currently do not have redundant sequencing facilities on a scale that could support our business. We perform all of our commercial genome sequencing in our facility located in Mountain View, California. Mountain View is situated on or near earthquake fault lines. Our facility, the equipment we use to perform our sequencing services and our other business process systems are costly to replace and could require substantial time to repair or replace. The facility may be harmed or rendered inoperable by natural or man-made disasters, including earthquakes, wildfires, floods, acts of terrorism or other criminal activities, infectious disease outbreaks and power outages, which may render it difficult or impossible for us to sequence genomes for some period of time. In addition, these events may temporarily interrupt our ability to receive samples from our customers or materials from our suppliers and our access to our various systems necessary to operate our business. The inability to perform our sequencing service would result in the loss of customers and harm our reputation. While we currently maintain approximately $40.0 million in property insurance coverage, we do not currently have insurance coverage for damage arising from an earthquake. Our insurance covering damage to our property may not be sufficient to cover all of our potential losses and will not cover us in the event of an earthquake, and may not continue to be available to us on acceptable terms, or at all.

Failure to achieve expected sequencing process yields, or variability in our sequencing process yields, could harm our operating results and damage our reputation.

Our sequencing process, like any other commercial-scale production process, is not flawless. For example, our DNBs may not adhere to all of the sticky spots on the surface of the silicon wafers we use to sequence DNA, or parts of the wafers may be unreadable. We refer to the efficiency of our sequencing process as its yield. The sequencing process yields we achieve depend on the design and operation of our sequencing process, which uses a number of complex and sophisticated biochemical, informatics, optical and mechanical processes. An operational or technology failure in one of these complex processes may result in sequencing processing yields that are lower than we anticipate or that vary between sequencing runs. In addition, we are regularly evaluating and refining our sequencing process. These refinements may initially result in unanticipated issues that further reduce our sequencing process yields or increase the variability of our sequencing yields. Low sequencing yields, or higher than anticipated variability, increases total sequencing costs and reduces the number of genomes we can sequence in a given time period, which can cause variability in our operating results and damage our reputation.

We may have to resequence genomes due to contamination of DNA samples or other failures in the sequencing process. In the past, we have had to resequence various genome samples as a result of contamination occurring in the sample preparation and library construction process. The sequencing process is highly sensitive, and the presence of any foreign substances during the preparation of the slide samples can corrupt the results of the sequencing process. The quality of our sequencing runs may also vary for other reasons. Resequencing requires additional expense, time and capacity and delays the recognition of revenue from the service. Samples may be contaminated in the future or the quality of our sequencing results may vary, which may damage our reputation and decrease the demand for our service.

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Mishandling or switching of DNA samples or genomic data may harm our reputation and result in litigation against us.

We may unintentionally mishandle DNA samples. For example, if customer samples or sequencing results are switched, our customers would receive the wrong sequencing data, which could have significant consequences, particularly if that data is used to diagnose or treat disease. Mishandling customer samples or data could lead to loss of current or future business, harm our reputation and result in litigation against us.

If we are not successful in reducing the average cost of our sequencing service, demand for our services, and therefore our business, will suffer.

Our ability to expand our customer base depends highly on our ability to reduce the average cost of sequencing a human genome. For example, certain academic or government-sponsored research organizations may forgo or delay whole genome-wide studies based on the cost required to sequence complete human genomes, in favor of other less expensive studies. Additionally, certain of our target customers may decide it is more cost-effective to purchase sequencing instruments from a competitor than contract for our sequencing service. To compete effectively with competitors who sell and market sequencing instruments, our service must provide cost advantages, superior quality and time savings over the purchase of sequencing instruments. In addition, as new competitors enter the market or expand their business model to include sequencing services, or as the price of competitor sequencing services decreases, we expect increased pricing pressure, which may force us to decrease the price of our genome sequencing service. Our gross profit and operating results will suffer if we are unable to offset any reductions in our prices by reducing our costs by developing new or enhanced technologies or methods, or increasing our sales volumes.

Reduction or delay in research and development budgets and government funding may adversely impact our sales.

We expect that for the foreseeable future, our revenue will be derived primarily from selling our genome sequencing service to a relatively small number of academic, governmental and other research institutions, as well as pharmaceutical and other life science companies. Our revenue may decline substantially due to reductions and delays in research and development expenditures by these customers, which depend, in part, on their budgets and the availability of government funding. Factors that could affect the spending levels of our customers include:

- weakness in the global economy and changing market conditions that affect our customers;
- changes in the extent to which the pharmaceutical and life science industry may use genetic information and genetic testing as a methodology for drug discovery and development;
- changes in government programs that provide funding to companies and research institutions;
- changes in the regulatory environment affecting pharmaceutical and life science companies and research;
- impact of consolidation within the pharmaceutical and life science industry; and
- cost-reduction initiatives of customers.

Also, government funding of research and development is subject to the political process, which is inherently unpredictable. Any reduction in the funding of life science research and development or delay surrounding the approval of government budget proposals may cause our customers to delay or forgo purchases of our services. A reduction or delay in demand for our service will adversely affect our ability to achieve profitability.

The timing and extent of funding provided by the American Recovery and Reinvestment Act of 2009 could adversely affect our business, financial condition or results of operations.

In February 2009, the U.S. government enacted the American Recovery and Reinvestment Act of 2009, which we refer to as the Recovery Act, to provide stimulus to the U.S. economy in the wake of the economic downturn. As part of the Recovery Act, over $10 billion in research funding was provided to the National Institutes of Health, or NIH, through September 2010 to support the advancement of scientific research. A portion of the stimulus funding supported the analysis of genetic variation and biological function and may have a significant positive long-term impact on our business and the industry generally. In the short-term, however, potential customers may delay or forgo their purchases of our services as they wait to learn whether, and to what extent, they will receive stimulus funding. If potential customers are unable to obtain stimulus money, they may reduce their research and development budgets, resulting in a decrease in demand for our service. In addition, even if potential customers receive these stimulus funds, they may not purchase our services, and we may not benefit from the Recovery Act.

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Ethical, legal and social concerns related to the use of genetic information could reduce demand for our genome sequencing services.

Our genome sequencing services are intended to facilitate large-scale human genome studies for a wide variety of diagnostic and discovery applications. However, genetic testing has raised ethical, legal and social issues regarding privacy and the appropriate uses of the resulting information. Governmental authorities could, for social or other purposes, limit or regulate the use of genetic testing or prohibit testing for genetic predisposition to certain conditions, particularly for those that have no known cure. Similarly, these concerns may lead individuals to refuse to use genetics tests even if permissible.

In addition, we do not control how our customers use the genomic data we provide. In most cases, we do not know the identity of the individuals whose DNA we sequence, the reason why their DNA is being sequenced or the intended use of the genomic data we provide. If our customers use our services or the resulting genomic data irresponsibly or in violation of legal restrictions, our reputation could be harmed and litigation may be brought against us.

Ethical and social concerns may also influence U.S. and foreign patent offices and courts with regard to patent protection for technology relevant to our business. These and other ethical, legal and social concerns may limit market acceptance of our technology for certain applications or reduce the potential markets for our technology, either of which could have an adverse effect on our business, financial condition or results of operations.

We use biological and hazardous materials that require considerable expertise and expense for handling, storage and disposal and may result in claims against us.

We work with materials, including chemicals, biological agents and compounds and DNA samples that could be hazardous to human health and safety or the environment. Our operations also produce hazardous and biological waste products. Federal, state and local laws and regulations govern the use, generation, manufacture, storage, handling and disposal of these materials and wastes. Compliance with applicable environmental laws and regulations is expensive, and current or future environmental laws and regulations may restrict our operations. If we do not comply with applicable regulations, we may be subject to fines and penalties.

In addition, we cannot eliminate the risk of accidental injury or contamination from these materials or wastes. While our property insurance policy provides limited coverage in the event of contamination from hazardous and biological products and the resulting cleanup costs, we do not currently have any additional insurance coverage for legal liability for claims arising from the handling, storage or disposal of hazardous materials. Further, our general liability insurance and workers compensation insurance policies do not cover damages and fines arising from biological or hazardous waste exposure or contamination. Accordingly, in the event of contamination or injury, we could be liable for damages or penalized with fines in an amount exceeding our resources and our operations could be suspended or otherwise adversely affected.

We have limited selling and marketing resources and may be unable to successfully commercialize our human genome sequencing service.

To grow our business as planned, we must expand our sales, marketing and customer support capabilities. We may be unable to attract, retain and manage the specialized workforce necessary to gain market acceptance and successfully commercialize our services. In addition, developing these functions is time consuming and expensive.

The sale of genome sequencing services involves extensive knowledge about genomic research and sequencing technology, including the sequencing technology of our competitors. To be successful, our sales force and related personnel must be technically proficient in a variety of disciplines. For example, many of our existing salespersons have a

7,366

Depreciation and amortization

2,353

2,509

1,958

1,953

2,813

Costs of terminated acquisitions

-

53

-

57

135

Goodwill and asset impairment charges

2,529

8,225

3,798

1,165

-

Operating (loss) income

(1,473
)

(7,831
)

(2,058
)

1,803

3,813

Interest expense, net

(1,794
)

(1,890
)

(1,963
)

(2,219
)

(2,885
)

Other income

686

267

438

327

514

(Loss) income before income taxes

(2,581
)

(9,454
)

(3,583
)

(89
)

1,442

Income tax expense (benefit)

2,439

(3,044
)

(50
)

(32
)

534

(Loss) income before cumulative effect of change in accounting principle

(5,020
)

(6,410
)

(3,533
)

(57
)

908

Cumulative effect of change in accounting principle, net of tax benefit of $2,188

-

-

-

(5,733

)

-

Net (loss) income

$

(5,020

)
$

(6,410

)
$

(3,533

)
$

(5,790

)
$

908

Basic (loss) income per share

(Loss) income before cumulative effect of change in accounting principle

$

(0.33

)
$

(0.47

)
$

(0.28

)
$

-

$

0.07

Cumulative effect of change in accounting principle

-

-

-

(0.46

)

-

Net (loss) income

$

(0.33

)

$
(0.47
)
$
(0.28
)
$
(0.46
)
$
0.07

Weighted average number of shares outstanding

15,271,637

13,679,604

12,414,816

12,630,964

12,724,282

Diluted (loss) income per share

(Loss) income before cumulative effect of change in accounting principle

$
(0.33
)
$
(0.47
)
$
(0.28
)
$
-

$
0.07

Cumulative effect of change in accounting principle

-

-

-

(0.46
)

-

Net (loss) income

$
(0.33
)

$
(0.47
)
$
(0.28
)
$
(0.46
)
$
0.07

Weighted average number of shares outstanding

15,271,637

13,679,604

12,414,816

12,630,964

12,742,122

	Year ended December 31,				
	2005	2004	2003	2002	2001
			(In thousands)		
Balance Sheet Data (at end of period):					
Working capital (deficit)	$ 14,615	$ 17,471	$ 270	$ (2,210)	$ 4,809
Intangible assets, net	$ 6,148	$ 6,522	$ 11,614	$ 14,389	$ 21,132
Total assets	$ 96,111	$ 102,757	$ 90,602	$ 96,288	$ 104,670
Long-term debt, including current maturities	$ 26,674	$ 29,195	$ 31,286	$ 33,312	$ 34,349
Stockholders’ equity	$ 61,650	$ 66,522	$ 54,212	$ 57,669	$ 63,856

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion reviews our operations for each of the three years in the period ended December 31, 2005, and should be read in conjunction with our Consolidated Financial Statements and related notes thereto included elsewhere herein.

FACTORS INFLUENCING FUTURE RESULTS AND ACCURACY OF FORWARD-LOOKING STATEMENTS

This report includes forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended ("Forward-Looking-Statements"). All statements other than statements of historical fact included in this report are Forward-Looking-Statements. Although we believe that the expectations reflected in such Forward-Looking Statements are reasonable, we can give no assurance that such expectations will prove to be correct. Generally, these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of such plans or strategies, number of acquisitions, and projected or anticipated benefits from acquisitions made by or to be made by us, or projections involving anticipated revenues, earnings, levels of capital expenditures or other aspects of operating results. All phases of our operations are subject to a number of uncertainties, risks, and other influences, many of which are outside our control and any one of which, or a combination of which, could materially affect the results of our operations and whether Forward-Looking Statements made by us ultimately prove to be accurate. Such important factors that could cause actual results to differ materially from our expectations are disclosed in *Item 1A Risk Factors* of this report. All subsequent written and oral Forward-Looking Statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by the important factors described below that could cause actual results to differ from our expectations. The Forward- Looking Statements made herein are only made as of the date of this filing, and we undertake no obligation to publicly update such Forward-Looking Statements to reflect subsequent events or circumstances.

Introduction

Revenues

Car and Truck Wash Services

We own full service, exterior only and self-service car wash locations in New Jersey, Pennsylvania, Delaware, Texas, Florida and Arizona, as well as truck washes in Arizona, Indiana, Ohio and Texas. We earn revenues from washing and detailing automobiles; performing oil and lubrication services, minor auto repairs, and state inspections; selling fuel; and selling merchandise through convenience stores within the car wash facilities. Revenues generated for 2005 for the Car and Truck Wash Segment were comprised of approximately 81% from car washing and detailing, 8% from lube and other automotive services, and 11% from fuel and merchandise. The majority of revenues from our Car and Truck Wash Segment are collected in the form of cash or credit card receipts, thus minimizing customer accounts receivable.

Weather has had a significant impact on volume and revenue at the individual locations. We believe that the geographic diversity of our operating locations in different regions of the country helps mitigate the risk of adverse weather-related influence on our volume.

Security

Our Security Segment designs, manufactures, markets and sells a wide range of products. The Company's primary focus in the Security Segment is the design of electronic surveillance products and components that it produces and sells, primarily to installing dealers, system integrators and end users. Other products in our Security Segment include, but are not limited to, less-than-lethal defense sprays, personal alarms, biometric locks, high-end digital and fiber optic cameras and plasma monitors. The main marketing channels for our products are industry shows, outside sales representatives, catalogs, internet, sales through a call center and sales through mass merchants and trade publications.

Cost of Revenues

Car and Truck Wash Services

Cost of revenues within the Car and Truck Wash Segment consists primarily of direct labor and related taxes and fringe benefits, certain insurance costs, chemicals, wash and detailing supplies, rent, real estate taxes, utilities, car damages, maintenance and repairs of equipment and facilities, as well as the cost of the fuel and merchandise sold.

Security

Cost of revenues within the Security Segment consists primarily of costs to purchase or manufacture the security products including direct labor and related taxes and fringe benefits, and raw material costs. Product warranty costs related to the Security Segment have been minimal in that the majority of customer product warranty claims are reimbursed by the supplier.

Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") expenses consist primarily of management, clerical and administrative salaries, professional services, insurance premiums, sales commissions, and other costs relating to marketing and sales.

We capitalize direct incremental costs associated with business acquisitions. Indirect acquisition costs, such as executive salaries, corporate overhead, public relations, and other corporate services and overhead are expensed as incurred.

Depreciation and Amortization

Depreciation and amortization consists primarily of depreciation of buildings and equipment, and amortization of leasehold improvements and certain intangible assets. Buildings and equipment are depreciated over the estimated useful lives of the assets using the straight-line method. Leasehold improvements are amortized over the shorter of their useful lives or the lease term with renewal options. Intangible assets, other than goodwill or intangible assets with indefinite useful lives, are amortized over their useful lives ranging from three to fifteen years, using the straight-line method.

Other Income

Other income consists primarily of rental income received on renting out excess space at our car wash facilities and includes gains and losses on the sale of property and equipment and gains and losses on short-term investments.

Income Taxes

Income tax expense is derived from tax provisions for interim periods that are based on the Company's estimated annual effective rate. Currently, the effective rate differs from the federal statutory rate primarily due to state and local income taxes, non-deductible costs related to acquired intangibles, and changes to the valuation allowance.

Results of Operations for the Three Years Ended December 31, 2005

The following table presents the percentage each item in the consolidated statements of operations bears to total revenues:

	Year ended December 31,		
	2005	2004	2003
Revenues	100.0%	100.0%	100.0%
Cost of revenues	72.9	73.0	73.1
Selling, general and administrative expenses	22.1	21.9	19.4
Depreciation and amortization	3.5	4.3	4.0
Costs of terminated acquisitions	-	0.1	-
Goodwill and asset impairment charges	3.7	14.3	7.7
Operating loss	(2.2)	(13.6)	(4.2)
Interest expense, net	(2.6)	(3.3)	(4.0)
Other income	1.0	0.5	0.9
Loss before income taxes	(3.8)	(16.4)	(7.3)
Income tax expense (benefit)	3.6	(5.3)	(0.1)
Net loss	(7.4)%	(11.1)%	(7.2)%

Revenues

Car and Truck Wash Services

Revenues for the year ended December 31, 2005 were $43.3 million as compared to $41.0 million for the year ended December 31, 2004, an increase of $2.3 million or 5.6%. Of the $43.3 million of revenues for the year ended December 31, 2005, $35.1 million or 81% was generated from car wash and detailing, $3.4 million or 8% from lube and other automotive services, and $4.8 million or 11% from fuel and merchandise sales. Of the $41.0 million of revenues for the year ended December 31, 2004, $33.4 million or 81% was generated from car wash and detailing, $3.5 million or 9% from lube and other automotive services, and $4.1 million or 10% from fuel and merchandise sales. The increase in wash and detailing revenues was principally due to an overall increase in consumer spending combined with an improvement in weather trends in the Company’s Arizona and East regions. This improvement was partially offset by a decline in volumes and revenues in the Florida region as a result of several severe hurricanes and related storm warnings. The Company also experienced reduced volumes in 2005 from the divesting of two of its car wash locations in the first half of 2004. Overall car wash volumes increased 6.4% in 2005 as compared to 2004. In addition to this increase in volume, the Company experienced an increase in average car wash and detailing revenues per car to $15.21 in 2005, from $15.14 in 2004. This increase in average wash and detailing revenue per car was the result of management’s continued focus on aggressively selling detailing and additional on-line car wash services. The increase in fuel and merchandise revenues is primarily the result of higher fuel prices and the addition of higher quality merchandise in our car wash lobbies. Management expects car wash volumes and revenues to continue at historic levels consistent with weather patterns.

Revenues for the year ended December 31, 2004 were $41.0 million as compared to $43.4 million for the year ended December 31, 2003, a decrease of $2.4 million or 5.5%. Of the $41.0 million of revenues for the year ended December 31, 2004, $33.4 million or 81% was generated from car wash and detailing, $3.5 million or 9% from lube and other automotive services, and $4.1 million or 10% from fuel and merchandise sales. Of the $43.4 million of revenues for the year ended December 31, 2003, $35.7 million or 82% was generated from car wash and detailing, $4.1 million or 10% from lube and other automotive services, and $3.6 million or 8% from fuel and merchandise sales. The decrease in wash and detailing revenues was principally due to an overall car wash volume decline of 10.2% in 2004 from 2003, including 3.9% from the closing or divesting of five car wash locations. Partially offsetting this decline in volume, the Company experienced an increase in average wash and detailing revenue per car to $15.14 in 2004, from $14.52 in 2003, a 4.3% increase. This increase in average wash and detailing revenue per car was the result of management’s continued focus on aggressively selling detailing and additional on-line car wash services. Revenue from lube and other automotive services was approximately $3.5 million in 2004 compared to $4.1 million in 2003, a decrease of $0.6 million or 15%. This decrease in revenue, principally within our Texas region, is the result of the reduction in car wash volume within this market combined with increased competition. The increase in fuel and merchandise revenues is primarily the result of higher fuel prices and the addition of higher quality merchandise in our car wash lobbies.

Security

Revenues of the Security Segment were approximately $24.9 million, $16.6 million and $5.6 million in 2005, 2004 and 2003, respectively. The increase in revenues is due principally to internal growth of approximately $2.5 million in sales within our Florida based electronic surveillance equipment operation, $5.2 million of sales growth generated by IVS and S&M in 2005, which we acquired in July of 2004, and therefore contributed revenues for only six months in 2004, and sales growth of $0.8 million generated by the Company's personal defense products operations. Management expects revenues to continue to increase in the electronic surveillance systems and personnel defense areas where the Company is expanding its sales staff and marketing efforts.

Cost of Revenues

Car and Truck Wash Services

Cost of revenues for the year ended December 31, 2005 were $32.1 million or 74% of revenues with car washing and detailing costs at 72% of respective revenues, lube and other automotive services costs at 76% of respective revenues, and fuel and merchandise costs at 88% of respective revenues. Cost of revenues for the year ended December 31, 2004 was $30.1 million, or 73% of revenues with car wash and detailing costs at 71% of respective revenues, lube and other automotive services costs at 78% of respective revenues, and fuel and merchandise costs at 87% of respective revenues. Cost of revenues, as a percent of revenues, was relatively consistent between 2004 and 2005.The Company experienced a slight decline in wash and detailing operating margins in 2005.

Cost of revenues for the year ended December 31, 2004 was $30.1 million or 73% of revenues with car washing and detailing costs at 71% of respective revenues, lube and other automotive services costs at 78% of respective revenues, and fuel and merchandise costs at 87% of respective revenues. Cost of revenues for the year ended December 31, 2003 was $32.3 million, or 74% of revenues with car wash and detailing costs at 73% of respective revenues, lube and other automotive services costs at 78% of respective revenues, and fuel and merchandise costs at 87% of respective revenues. The Company experienced a slight improvement in wash and detailing operating margins in 2004, despite a decrease in wash volume of 10.2% as compared to the prior year, as a result of a decline in insurance related claim costs, lease termination costs recorded in the prior year related to an underperforming car wash property closed in 2003, and the divestiture or closing of five unprofitable or marginally profitable car wash sites in 2003 and 2004. Additionally, due to management's emphasis on monitoring labor staffing on a daily basis, we were successful in maintaining relatively stable labor costs as a percent of revenues in 2004 and 2003 despite the decrease in volume.

Security

Cost of revenues were $17.7 million, or 71% of revenues, $12.0 million or 72% of revenues and $3.5 million or 62% of revenues for 2005, 2004 and 2003, respectively. The increase in cost of revenues in 2005 and 2004 as compared to 2003 is principally due to: growth in sales of advanced imaging components and video equipment sold by IVS, which we began selling in July 2004 when we acquired IVS, which have gross profit margins typically lower than less-then-lethal defense sprays; an increase in sales of monitors; and an increase in sales to larger distributors and systems installers at lower profit margins.

Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") expenses for the year ended December 31, 2005 were $15.0 million compared to $12.6 million for the same period in 2004, an increase of approximately $2.4 million or 19%. SG&A costs as a percent of revenues were 21.9% in both 2005 and 2004. The increase in SG&A costs is primarily the result of growth of the Security Segment, which added $2.1 million of SG&A costs in 2005. The SG&A cost increase in the Security Segment was comprised of $1.2 million related to the "do it yourself" video surveillance system business and the advanced imaging components and video equipment business acquired in July 2004 as well as a $700,000 increase in costs of our existing Ft. Lauderdale, Florida-based electronic surveillance equipment operation. These increases were in the areas of marketing and selling costs and administrative personnel costs as additional staff were added to handle planned growth. Corporate SG&A costs decreased slightly in 2005 as compared to 2004 due to a reduction in payroll costs and legal expenses, partially offset by increased insurance costs and increased auditing and consulting fees related to preparation of the audit of internal controls over financial reporting as required by Section 404 of the Sarbanes Oxley Act of 2002. Management expects SG&A costs to increase in the future as the Company continues to expand its security operations.

Selling, general and administrative expenses for the year ended December 31, 2004 were $12.6 million compared to $9.5 million for the same period in 2003, an increase of approximately $3.1 million or 33%. SG&A costs as a percent of revenues were 21.9% for 2004 as compared to 19.4% in 2003. The increase in SG&A costs is primarily the result of growth of the Security Segment, which added $2.5 million of SG&A costs in 2004, and an increase of $497,000 in Corporate SG&A costs. The SG&A cost increase in the Security Segment was comprised of $1.6 million related to the "do it yourself" video surveillance system business and the advanced imaging components and video equipment camera business acquired in July 2004 including $105,000 of transaction and integration costs as well as increases in costs of our existing Ft. Lauderdale, Florida based video surveillance systems operation. These increases were in the areas of marketing and selling costs and administration personnel costs as additional staff was added to handle planned growth. Corporate cost increases related principally to increased insurance costs, the cost of settling a legal matter for $55,000, and a management bonus and increased corporate salaries totaling $298,000 in 2004.

Depreciation and Amortization

Depreciation and amortization totaled $2.4 million, $2.5 million and $2.0 million for 2005, 2004 and 2003, respectively. In the fourth quarter of 2004, the Company recorded an adjustment to reflect the appropriate balances for certain assets classified as buildings and leasehold improvements that had been depreciated using incorrect useful lives. Specifically, the Company recognized $338,000 in additional depreciation and amortization expense in its consolidated statement of operation for the quarter ended December 31, 2004 to correct the aforementioned error in accounting. We decided to record the correction in the current period and not restate our previously issued financial statements after taking into consideration (i) that the adjustment, net of applicable income taxes, did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; and (ii) that the cumulative impact of the adjustment on stockholders' equity was not material to the financial statements of prior interim or annual periods.

Costs of Terminated Acquisitions

Our policy is to charge as an expense any previously capitalized expenditures relating to proposed acquisitions that in our current opinion will not be consummated. The costs of previously capitalized expenditures related to proposed acquisitions totaled approximately $0, $53,000 and $0 in 2005, 2004 and 2003, respectively. These costs, which principally related to several possible acquisitions we pursued in the Security Segment, are primarily related to due diligence costs.

Asset Impairment Charges

In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we periodically review the carrying value of our long-lived assets held and used, and assets to be disposed of, for possible impairment when events and circumstances warrant such a review. Assets classified as held for sale are measured at the lower of carrying value or fair value, net of costs to sell. During the year ended December 31, 2002, we wrote down assets determined to be impaired by approximately $1.2 million. The asset write-down related to one of our full service car wash sites in Texas and two full service car wash sites in Arizona. We have determined that due to changing demographics and increased competition in the geographic areas of these sites, their future expected cash flows will not be sufficient to recover their respective carrying values. During the quarter ended June 30, 2003, we further wrote down the assets related to one of the full service car wash sites in Arizona, which we partially wrote down at December 31, 2002, by an additional $351,000. The additional write-down was the result of the impending loss of a significant customer of this site resulting in an additional reduction of the future expected cash flows of this site and the ability to recover the site's carrying value. We closed the facility effective September 30, 2003. During the quarter ended June 30, 2004, we sold the other Arizona car wash site recording a loss of $51,000 on the disposition. We continue to market the Texas site for sale and have written down these assets to their estimated fair market values. Additionally, during the year ended December 31, 2004, we wrote down assets related to our truck wash operations determined to be impaired by approximately $500,000 and we wrote these assets down an additional $966,000 during the quarter ended September 30, 2005 as a result of our SFAS 144 quarterly reviews. We have determined that due to a reduction in truck wash volumes resulting from an increase in inclement weather, increased competition, the significant increase in fuel costs which had the effect of reducing spending on truck washing, and demographic changes to certain of our facilities, their future expected cash flows would not be sufficient to recover their respective carrying values. The Company executed a lease-to-sell agreement on December 31, 2005 with Eagle United Truck Wash, LLC ("Eagle") to lease Mace's five truck washes beginning January 1, 2006 for up to two years. Pursuant to the terms of the agreement, Eagle must pay Mace $9,000 per month to lease the Company's truck washes, and is responsible for all underlying property expenses. Within the next two years, Eagle is obligated under the agreement to purchase the truck washes and be delivered title to the assets for $1.2 million, consideration consisting of $280,000 cash and a $920,000 note payable to Mace secured by mortgages on the truck washes. When issued, the $920,000 note will have a five-year term, with principal and interest paid on a 15-year amortization schedule. If Eagle does not fulfill its obligation to purchase the truck washes, the Company will regain possession of the truck washes and Eagle will be obligated to pay $200,000 as liquidated damages.

In the fourth quarter of 2005, as a result of the annual impairment test of Goodwill and Other Intangibles in accordance with SFAS 142, we recorded an impairment of approximately $1.56 million related to our Texas region reporting unit of our Car and Truck Wash Segment. In the fourth quarter of 2004, we recorded impairments of approximately $1.0 million and $6.7 million related to our Northeast and Texas reporting units, respectively. Additionally, in the fourth quarter of 2003, we recorded an impairment of approximately $3.4 million related to our Northeast region reporting unit of our Car and Truck Wash Segment. These 2005, 2004 and 2003 impairments were principally due to reductions in future projected cash flows resulting from extended departures from our historic revenue levels as a result of inclement weather, and increased competition near several of our facilities in Texas and New Jersey.

Interest Expense, Net

Interest expense, net of interest income, for the year ended December 31, 2005, was $1.8 million compared to $1.9 million for 2004. This decrease in our net interest expense was the result of an increase in interest income, partially offset by an increase in interest rates in 2005 on approximately 50% of our long-term debt which has interest rates tied to the prime rate.

Interest expense, net of interest income, for the year ended December 31, 2004, was $1.9 million compared to $2.0 million for 2003. This decrease in our interest expense was the result of a reduction in our outstanding debt as a result of routine monthly principal payments, partially offset by an increase in interest rates in the last quarter of 2004 on approximately 50% of our long-term debt which has interest rates tied to the prime rate.

Other Income

Other income was $686,000, $267,000, and $438,000 for 2005, 2004 and 2003, respectively. Included in 2005 are gains on the sale of fixed assets totaling $333,000 and gains on short-term investments of $264,000. Included in 2003 is a $107,000 gain on the sale of a car wash facility in our Northeast region.

Supplementary Cash Flow Information

Interest paid on all indebtedness was approximately $2.1 million, $2.0 million and $2.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. Income taxes paid were approximately $86,000, $340,000 and $144,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Noncash investing and financing activities of the Company excluded from the statement of cash flows include a property addition financed by common stock of $1.6 million, real estate partially funded by a mortgage of approximately $825,000, and the sale of property and simultaneous pay down of a related mortgage of $325,000, all in 2004 and property additions financed by debt of $343,000 in 2003.

Income Taxes

We recorded income tax expense of $2.4 million and income tax benefits of $3.0 million and $50,000 for the years ended December 31, 2005, 2004, and 2003, respectively. Income tax expense (benefit) reflects the recording of income taxes on loss before income taxes at effective rates of approximately (95)%, 32%, and 1% for the years ended December 31, 2005, 2004, and 2003, respectively. In 2004 and 2003 no income tax benefit was recorded with respect to the Northeast region reporting unit goodwill impairment charges of approximately $1.0 million and $3.4 million, respectively, due to the non-deductibility of the goodwill. The effective rate differs from the federal statutory rate for each year primarily due to state and local income taxes, non-deductible costs related to intangibles, and changes to the valuation allowance. In 2005 we wrote off approximately $120,000 of state net operating loss carryforwards (“NOL”) related to our truck washes.

Realization of the future tax benefits related to the deferred tax assets is dependent upon many factors, including the Company's ability to generate taxable income in future years. The Company performed a detailed review of the considerations influencing our ability to realize the future benefit of the NOLs, including, the extent of recently used NOLs, the turnaround of future deductible temporary differences, the duration of the NOL carryforward period, and the Company's future projection of taxable income. The Company increased its valuation allowance against deferred tax assets by $3.2 million in 2005 with a total valuation allowance of $4.1 million at December 31, 2005 representing the amount of its deferred income tax assets in excess of the Company's deferred income tax liabilities. The valuation allowance was recorded because management was unable to conclude that realization of the net deferred income tax asset was more likely than not. This determination was a result of the Company's continued losses in its fiscal year ended December 31, 2005, the uncertainty of the timing of the Company's transition from the Car Wash business, and the ultimate extent of growth in the Company's Security Segment.

Liquidity and Capital Resources

Liquidity

Cash and cash equivalents were $8.4 million at December 31, 2005. The ratio of our total debt to total capitalization, which consists of total debt plus stockholders' equity, was 30.2% at December 31, 2005, and 30.5% at December 31, 2004.The improvements in the Company's total debt to total capitalization ratio is directly related to routine principal payments on debt as noted below.

Our business requires a substantial amount of capital, most notably to pursue our expansion strategies, including our current expansion in the Security Segment, and for equipment purchases and upgrades for our Car and Truck Wash Segment. We plan to meet these capital needs from various financing sources, including borrowings, internally generated funds, and the issuance of common stock if the market price of the Company's stock is at a desirable level.

As of December 31, 2005, we had working capital of approximately $14.6 million. At December 31, 2004, working capital was approximately $17.5 million and $270,000 at December 31, 2003. The reduction in working capital at December 31, 2005 was principally due to a use of $1.9 million of cash for the acquisition of Securetek in November 2005. We experienced a significant improvement in working capital at December 31, 2004, primarily attributable to: 1) $8.95 million of proceeds received from the removal of a restriction on outstanding shares of the Company's common stock; 2) $9.4 million of proceeds, net of issuance costs, from the sale of approximately 1.9 million shares of the Company's common stock to two private institutions through three separate sale transactions and the sale of 150,000 shares of the Company's stock to Fusion under a Master Facility Agreement; 3) $1.9 million of proceeds from the exercise of common stock options; and 4) $795,000 of proceeds from the sale of an exterior-only car wash in New Jersey and a full-service car wash in Arizona. Working capital was also positively affected in 2004 by the renewal and reclassification to non-current liabilities of approximately $3.3 million of 15-year amortizing loans with Chase. The increase in working capital in 2004 was partially offset by the use of $5.6 million of cash for the acquisitions of IVS and S&M on July 1, 2004; capital expenditure investments for further growth within the Car and Truck Wash Segment and the Security Segment, as more fully detailed below; and the reclassification to current liabilities of an additional loan for $290,000 which was renewed in April 2005. Although the Company has been successful in renewing similar loans with the current lender in the past, including the renewal of loans in 2005 and 2004 totaling $290,000 and $3.3 million, respectively, there can be no assurance that our lender will continue to provide us with renewals or with renewals at favorable terms.

During the years ended December 31, 2005 and 2004, we made capital expenditures of $1.14 million and $1.46 million, respectively, within our Car and Truck Wash Segment. We estimate aggregate capital expenditures for our Car and Truck Wash Segment of approximately $800,000 for the year ending December 31, 2006. The Company believes its current cash and short-term investment balance at December 31, 2005 of $11.4 million and cash flow from operating activities in the remainder of 2006 will be sufficient to meet its car wash capital expenditure funding needs through at least the next twelve months. In years subsequent to 2006, we estimate that our Car and Truck Wash Segment will require annual capital expenditures of $650,000 to $800,000. Capital expenditures within our Car and Truck Wash Segment are necessary to maintain the efficiency and competitiveness of our sites. If the cash provided from operating activities does not improve in 2006 and future years and if current cash balances are depleted, we will need to raise additional capital to meet these ongoing capital requirements.

Capital Expenditures for our Security Segment were $424,000 and $3.8 million for the fiscal years ending December 31, 2005 and 2004, respectively. We used $1.9 million of cash for the acquisition of Securetek in November 2005. We spent approximately $4.9 million through June 30, 2004 in the initial development of our video surveillance systems operations in Ft. Lauderdale, Florida including the acquisition costs of Micro-Tech and Vernex and the cost of developing and purchasing inventory for our expanded product line. Additionally, on July 1, 2004 the Company paid approximately $5.6 million of cash for the acquisition of the S&M and IVS security operations. We also made capital expenditures in 2004 of approximately $1.9 million for the purchase and furnishing of a new facility in Farmers Branch, Texas for our S&M and IVS security operations. Approximately $825,000 of the Farmers Branch, Texas facility purchase price was financed with debt. We estimate capital expenditures for the Security Segment at approximately $100,000 for 2006, principally related to facility improvements and equipment for our Farmers Branch, Texas and Ft. Lauderdale, Florida operations.

We intend to continue to expend significant cash for the purchasing of inventory as we grow and introduce new video surveillance products in 2006 and in years subsequent to 2006. We anticipate that inventory purchases will be funded from cash collected from sales and working capital. At December 31, 2005, we maintained an unused $500,000 revolving credit facility with Chase to provide financing for additional video surveillance product inventory purchases. This revolving credit facility is subject to an availability calculation based on inventory and accounts receivable (as defined in our bank agreement). Based upon availability calculations at December 31, 2005, the full amount of the revolving credit facility is currently available. The amount of capital that we will spend in 2006 and in years subsequent to 2006 is largely dependent on the marketing success we achieve with our video surveillance systems and components. We believe our cash and short-term investments balance of $11.4 million at December 31, 2005 and the revolving credit facility will provide for growth in 2006. Unless our operating cash flow improves, our growth will be limited if we deplete our cash balance.

In the past, we have been successful in obtaining financing by selling common stock and obtaining mortgage loans. Our ability to obtain new financing can be adversely impacted by our stock price. Our failure to maintain the required current debt service coverage ratios on existing loans also adversely impacts our ability to obtain additional financing. We are reluctant to sell common stock at market prices below our per share book value. For the twelve month period ended December 31, 2005 we were in default on certain of our debt covenants. We obtained waivers from our lenders through January 1, 2007. Our ability to obtain new financing will be limited if our stock price is not above our per share book value and our cash from operating activities does not improve. Currently, we cannot incur additional long term debt without the approval of one of our commercial lenders. The Company must demonstrate that the cash flow benefit from the use of new loan proceeds exceeds the resulting future debt service requirements.

Debt Capitalization and Other Financing Arrangements

At December 31, 2005, we had borrowings, including capital lease obligations, of approximately $26.7 million. We had three letters of credit outstanding at December 31, 2005, totaling $1,078,000 as collateral relating to workers' compensation insurance policies. We maintain a $500,000 revolving credit facility, subject to an availability calculation based on inventory and accounts receivable, to provide financing for additional video surveillance product inventory purchases. There were no borrowings outstanding under the revolving credit facility at December 31, 2005. The Company also maintains a $600,000 line of credit for commercial letters of credit for the importation of inventory. There were no outstanding commercial letters of credit under this commitment at December 31, 2005.

Several of our debt agreements, as amended, contain certain affirmative and negative covenants and require the maintenance of certain levels of tangible net worth, maintenance of certain unencumbered cash and marketable securities balances, limitations on capital spending and the maintenance of certain debt service coverage ratios on a consolidated level.

At December 31, 2005, we were not in compliance with our semi-annual consolidated debt coverage ratio of at least 1.25:1 related to our GMAC notes payable. The Company's debt coverage ratio related to the GMAC notes payable was 1.07:1 at December 31, 2005. Additionally, the Mace guaranty agreement with GMAC requires the Company to provide GMAC audited, reviewed, or compiled financial statements by the Company's independent certified public accountants within 90 days of the Company's fiscal year end. The Company was not able to timely provide the required year end audited financial statements. GMAC granted us a waiver of acceleration related to the non-compliance with the debt coverage ratio covenant and delinquency in providing the Company's year end audited financial statements at December 31, 2005, and for measurement periods through April 1, 2007 and, accordingly, a portion of the GMAC notes payable was reflected as non-current on our financial statements at December 31, 2005. If we are not able to increase our debt coverage ratio to at least 1.25:1, or we cannot obtain further waivers of acceleration, the GMAC notes may be reflected as current in future balance sheets and as a result our stock price may decline.

The Company has entered into amendments to the Chase term loan agreements effective March 31, 2004. The amended debt coverage ratio with Chase requires the Company to maintain a ratio of consolidated earnings before interest, income taxes, depreciation and amortization to debt service of 1.05:1 at December 31, 2005 and thereafter. The Company's debt coverage ratio was 1.09:1 at December 31, 2005 which was in compliance with this Chase covenant as amended. The amended Chase term loan agreement also limits capital expenditures annually to $1.0 million and requires the Company to provide Chase with a Form 10-K and audited financial statements within 120 days of the Company's fiscal year end as well as internal certified financial statements and a Form 10-Q within 60 days after the end of each fiscal quarter. The Company was not able to timely provide the required year end audited financial statements or the first quarter Form 10-Q. The Company incurred capital expenditures of $1.4 million in 2005 and, accordingly, was not in compliance with this Chase covenant. The Company received a waiver of acceleration from Chase at December 31, 2005 and for measurement periods through January 1, 2007 related to exceeding the annual capital expenditure limit and the untimely financial statement filings and, accordingly, a portion of the Chase notes payable was reflected as non-current on our financial statements at December 31, 2005. The Chase amendment also requires the maintenance of a minimum total unencumbered cash and marketable securities balance of $5 million. This cash balance requirement will be lowered to $1 million upon the Company returning to a debt coverage ratio of at least 1.10 to 1. If we are unable to satisfy these covenants or obtain further waivers, the Chase notes may be reflected as current in future balance sheets and as a result our stock price may decline.

The Company sold or closed six unprofitable or marginally profitable car wash facilities and a lube facility in 2003, 2004 and 2005 and increased its prices in March 2004 within the Car and Truck Wash Segment to help improve cash flows for fiscal 2004 and 2005. If our future cash flows are less than expected or debt service including interest expense increases more than expected causing us to further default on any of the Chase covenants or the GMAC covenant in the future, the Company will need to obtain further amendments or waivers from these lenders. If the Company is unable to obtain waivers or amendments in the future, Chase debt currently totaling $13.4 million and GMAC debt currently totaling $9.7 million, including debt recorded as long-term debt at December 31, 2005, would become payable on demand by the financial institution upon expiration of the current waivers.

The Company's ongoing ability to comply with its debt covenants under its credit arrangements and refinance its debt depends largely on the achievement of adequate levels of cash flow. Our cash flow has been and could continue to be adversely affected by weather patterns, economic conditions, and the requirements to fund the growth of our security business. In the event that non-compliance with the debt covenants should reoccur, the Company would pursue various alternatives to attempt to successfully resolve the non-compliance, which might include, among other things, seeking additional debt covenant waivers or amendments, or refinancing debt with other financial institutions. There can be no assurance that further debt covenant waivers or amendments would be obtained or that the debt would be refinanced with other financial institutions at favorable terms. If we are unable to obtain renewals on maturing loans or refinancing of loans on favorable terms, our ability to operate would be materially and adversely affected.

On March 13, 2006, the Company learned that the United States Attorney for the Eastern District of Pennsylvania is conducting a criminal investigation regarding the alleged hiring of undocumented workers at the Company's car washes. See Item 3, Legal Proceedings. From March 13, 2006 through May 31, 2006, the Company incurred $390,000 in legal, consulting and accounting expenses associated with the Audit Committee investigations and $375,000 associated with the governmental investigation and Company's defense and negotiations with the government. In accordance with the Company's By-Laws, the Company is obligated to indemnify and advance legal costs for its officers and directors. Due to the ongoing nature of the criminal investigation, it is not possible at this time to predict the outcome of the investigation or the impact of costs of ultimately resolving this matter. However, we believe that additional legal and other costs and expenses through the remainder of 2006 may be significant as we work to resolve the criminal investigation. In addition, we may be required to make substantial payments for fines, penalties or settlements in connection with the resolution of alleged violations of laws. Any such expenses or payments could have a material adverse effect on our liquidity and capital resources.

The Company is obligated under various operating leases, primarily for certain equipment and real estate within the Car and Truck Wash Segment. Certain of these leases contain purchase options, renewal provisions, and contingent rentals for our proportionate share of taxes, utilities, insurance, and annual cost of living increases.

The following are summaries of our contractual obligations and other commercial commitments at December 31, 2005 (in thousands):

		Payments Due By Period			
Contractual Obligations (1)	**Total**	**Less than One Year**	**One to Three Years**	**Three to Five Years**	**More Than Five Years**
Long-term debt (2)	$ 26,589	$ 2,154	$ 9,430	$ 8,604	$ 6,401
Capital leases (2)	85	55	30	-	-
Minimum operating lease payments	5,812	919	1,608	969	2,316
	$ 32,486	$ 3,128	$ 11,068	$ 9,573	$ 8,717

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Other Commercial Commitments	Total	Amounts Expiring Per Period Less Than One Year	One to Three Years	Three to Five Years	More Than Five Years
Line of credit (3)	$ -	$ -	$ -	$ -	$ -
Standby letters of credit (4)	1,078	1,078	-	-	-
	$ 1,078	$ 1,078	$ -	$ -	$ -

(1) Potential amounts for inventory ordered under purchase orders are not reflected in the amounts above as they are typically cancelable prior to delivery and, if purchased, would be sold within the normal business cycle.
(2) Related interest obligations have been excluded from this maturity schedule. Our interest payments for the next twelve month period, based on current market rates, are expected to be approximately $2.0 million.
(3) The Company maintains a $500,000 line of credit with Chase. There were no borrowings outstanding under this line of credit at December 31, 2005.
(4) The Company also maintains a $600,000 line of credit for commercial letters of credit with Chase for the importation of inventory. There were no outstanding commercial letters of credit under this commitment at December 31, 2005. Outstanding letters of credit of $1,078,000 represent collateral for workers' compensation insurance policies.

Mace currently employs Louis D. Paolino, Jr. as its President and Chief Executive Officer under a three-year employment agreement dated August 12, 2003. The principal terms of the employment agreement include: an annual salary of $400,000; a car at a lease cost of $1,500 per month, provision for certain medical and other employee benefits; prohibition against competing with Mace during employment and for a three-month period following a termination of employment; and a $2.5 million payment in the event that Mr. Paolino's employment is terminated for certain reasons set forth in the employment agreement. The termination payment is not due in the event of termination due to death or disability or certain prohibited conduct, as more fully set forth in the employment agreement. The termination payment is due if Mr. Paolino is terminated for unsatisfactory job performance. The employment agreement also entitles Mr. Paolino to a $2.5 million change-of-control bonus.

The Master Facility Agreement between the Company and Fusion Capital Fund II, LLC ("Fusion") and the Equity Purchase Agreement between the Company and Fusion was terminated on April 21, 2004. Under the Master Facility Agreement, the Company had entered into an Equity Purchase Agreement on April 17, 2000. Under the Equity Purchase Agreement, Fusion had the right and obligation to purchase up to $10 million of the Company's common stock under certain conditions. On April 21, 2004, the Company and Fusion entered into a termination and release agreement under which the Company sold Fusion 150,000 registered shares of the Company's common stock at $2.32 per share and terminated the Equity Purchase Agreement.

Cash Flows

Operating Activities. Net cash provided by operating activities totaled $1.3 million for the year ended December 31, 2005 and $1.2 million in 2004. The Company used approximately $638,000 in cash for working capital accounts. The cash used for working capital was mainly due to increases in accounts receivable, inventory and prepaid expenses as the Company continues to grow and expand its product offerings within its security operations. The Company also incurred $2.4 million of non-cash depreciation and amortization expense, and a non-cash reserve against deferred tax assets of $3.2 million.

Net cash provided by operating activities totaled $1.2 million for the year ended December 31, 2004 and $137,000 in 2003. The Company generated approximately $147,000 in cash from working capital accounts. The cash generated from working capital was mainly due to increases in accounts payable and accrued expenses. This was partially offset by growth in the Company's inventory of approximately $1.4 million from December 31, 2003 to December 31, 2004. The increase in inventory was due primarily to growth within our existing Ft. Lauderdale, Florida and recently acquired Farmers Branch, Texas video surveillance systems and components operations. The Company also incurred $2.5 million of non-cash depreciation and amortization expense.

Investing Activities. Cash used in investing activities totaled $4.8 million for the year ended December 31, 2005, which includes $1.9 million for the November 23, 2005 acquisition of Securetek, $1.0 million for capital expenditures relating to ongoing car care operations, $420,000 for capital expenditures relating to the Security Segment, and $2.6 million for the purchase of short-term investments. These expenditures were partially offset by proceeds of approximately $1.1 million received from the sale of fixed assets.

Cash used in investing activities totaled $7.8 million for the year ended December 31, 2004, which includes $5.6 million for the July 1, 2004 acquisition of IVS and S&M, $1.5 million for capital expenditures relating to ongoing car care operations, and $1.4 million for capital expenditures relating to the Security Segment. These expenditures were partially offset by proceeds of approximately $795,000 received from the sale of an exterior-only car wash in New Jersey and a full-service car wash in Arizona. Cash used in investing activities totaled $569,000 for the year ended December 31, 2003 which includes $873,000 for capital expenditures relating to ongoing car care operations, and $234,000 for the Security Segment. These amounts were partially offset by $598,000 of cash proceeds from the sale of a car wash facility in our Northeast region.

Financing Activities. Cash used in financing activities was $2.6 million for the year ended December 31, 2005, which consisted primarily of routine principal payments on debt.

Cash provided by financing activities was $17.6 million for the year ended December 31, 2004 which includes $11.3 million of proceeds from the issuance of common stock and the exercise of stock options and $8.95 million of proceeds from the removal of restrictions on shares, partially offset by routine principal payments on debt of $2.6 million. Cash used in financing activities was $2.3 million for the year ended December 31, 2003 which was principally for routine principal payments on debt.

Seasonality and Inflation

The Company believes that its car washing and detailing operations are adversely affected by periods of inclement weather. In particular, long periods of rain and cloudy weather adversely affect our car wash volumes and related lube and other automotive services as people typically do not wash their cars during such periods. Additionally, extended periods of warm, dry weather, usually encountered during the Company’s third quarter, may encourage customers to wash their cars themselves which also can adversely affect our car wash business. The Company has attempted to mitigate the risk of unfavorable weather patterns by having operations in diverse geographic regions. The Company also experiences a seasonal reduction in volume during the third quarter within the Company’s Arizona and Florida regions as a result of a migration of a significant portion of those areas’ populations to cooler climates. The Company does not believe its security operations are subject to seasonality.

The Company believes that inflation and changing prices have not had, and are not expected to have, a material adverse effect on its results of operations in the near future.

Summary of Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the Company's financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. The Company’s critical accounting policies are described below.

Revenue Recognition and Deferred Revenue

Revenues from the Company’s Car and Truck Wash Segment are recognized, net of customer coupon discounts, when services are rendered or fuel or merchandise is sold. The Company records a liability for gift certificates, ticket books, and seasonal and annual passes sold at its car care locations but not yet redeemed. The Company estimates these unredeemed amounts based on gift certificate and ticket book sales and redemptions throughout the year as well as utilizing historical sales and tracking of redemption rates per the car washes’ point-of-sale systems. Seasonal and annual passes are amortized on a straight-line basis over the time during which the passes are valid.

Revenues from the Company's Security Segment are recognized when shipments are made. Shipping and handling charges billed are included in revenues; the cost of which is included in selling, general and administrative ("SG&A") expenses.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash, highly liquid short-term investments with original maturities of three months or less, and credit card deposits which are converted into cash within two to three business days.

Short-Term Investments

At December 31, 2005, the Company had approximately $3.0 million of investments classified as available for sale in three funds which are stated at market value. The Company may exit one of the funds at the end of any calendar quarter with 30 days advanced written notice and the other funds may be exited with one business day notice. In the year ended December 31, 2005, the Company realized a total gain of $264,000. Additionally, an unrealized gain, net of tax, of approximately $156,000 is included as a separate component of equity in Accumulated Other Comprehensive Income (Loss) at December 31, 2005.

Impairment of Long-Lived Assets

In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we periodically review the carrying value of our long-lived assets held and used, and assets to be disposed of, when events and circumstances warrant such a review. If significant events or changes in circumstances indicate that the carrying value of an asset or asset group may not be recoverable, we perform a test of recoverability by comparing the carrying value of the asset or asset group to its undiscounted expected future cash flows. Cash flow projections are sometimes based on a group of assets, rather than a single asset. If cash flows cannot be separately and independently identified for a single asset, we determine whether an impairment has occurred for the group of assets for which we can identify the projected cash flows. If the carrying values are in excess of undiscounted expected future cash flows, we measure any impairment by comparing the fair value of the asset group to its carrying value. If the fair value of an asset or asset group is determined to be less than the carrying amount of the asset or asset group, an impairment in the amount of the difference is recorded.

Goodwill

In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, the Company completed annual impairment tests as of November 30, 2005, 2004, and 2003, and will be subject to an impairment test each year thereafter and whenever there is an impairment indicator. The Company's annual impairment testing corresponds with the Company's determination of its annual operating budgets for the upcoming year. The Company's valuation of goodwill is based on a discounted cash flow model applying an appropriate discount rate to future expected cash flows and management's annual review of historical data and future assessment of certain critical operating factors, including security product sales and related costs, car wash volumes, average car wash and detailing revenue rates per car, wash and detailing labor cost percentages, weather trends and recent and expected operating cost levels. Estimating cash flows requires significant judgment including factors beyond our control and our projections may vary from cash flows eventually realized. Adverse business conditions could affect recoverability of goodwill in the future and, accordingly, the Company may record additional impairments in subsequent years.

Other Intangible Assets

Other intangible assets consist primarily of deferred financing costs, customer lists, product lists, trademarks, and a registered national brand name. In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, our trademarks and brand name are considered to have indefinite lives, and as such, are not subject to amortization. These assets are tested for impairment using discounted cash flow methodology annually and whenever there is an impairment indicator. Estimating future cash flows requires significant judgment and projections may vary from cash flows eventually realized. Several impairment indicators are beyond our control, and cannot be predicted with any certainty whether or not they will occur. Deferred financing costs are amortized on a straight-line basis over the terms of the respective debt instruments. Customer lists, product lists, and non-compete agreements are amortized on a straight-line basis over their respective estimated useful lives.

Income Taxes

Deferred income taxes are determined based on the difference between the financial accounting and tax bases of assets and liabilities. Deferred income tax expense (benefit) represents the change during the period in the deferred income tax assets and deferred income tax liabilities. Deferred income tax assets include tax loss and credit carryforwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred income tax assets will not be realized.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We are not materially exposed to market risks arising from fluctuations in foreign currency exchange rates, commodity prices, or equity prices.

Interest Rate Exposure

A significant portion of our debt is at fixed rates, and as such, changes in market interest rates would not significantly impact operating results unless and until such debt would need to be refinanced at maturity. Substantially all of our variable rate debt obligations are tied to the prime rate, as is our incremental borrowing rate. A one percent increase in the prime and Libor rates would not have a material effect on the fair value of our variable rate debt at December 31, 2005 and would have had the impact of increasing interest expense by approximately $160,000 in 2005.

On October 14, 2004, we entered into an interest rate cap that effectively changes our interest rate exposure on approximately $7 million of variable rate debt. The variable rate debt floats at prime plus .25% (7.50% at December 31, 2005). The hedge contract has a 36-month term and caps the interest rate on the $7 million of variable rate debt at 6.5%. The derivative is designated as a cash flow hedge and, accordingly, is marked to market with gains and losses on the contract reported as a component of other comprehensive income (loss) and is classified into earnings in the earlier of (i) the period the hedged transaction affects earnings, or (ii) the termination of the hedge contract. At December 31, 2005, the contract which was originally purchased for $124,000, is included in other assets at its fair market value of approximately $130,000.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The reports of independent registered public accounting firm and Consolidated Financial Statements are included in Part IV, ITEM 15 of this Report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's disclosure controls and procedures are designed to ensure that information required to be disclosure by the Company in the reports that its files or submits under Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commissions' rules, and include controls and procedures designed to ensure that such information is accumulated and communicated to the Company's management, including its principal executive and financial officers, to allow timely decisions regarding required disclosure. Based on the evaluation of the effectiveness of the Company's disclosure controls and procedures as of December 31, 2005 required by Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended, and conducted by the Company's chief executive officer and chief financial officer, such officers concluded that the Company's disclosures controls and procedures were not effective as of December 31, 2005. That conclusion was based on the fact that, during the first quarter of 2006, the Company identified a material weakness in its internal control over financial reporting.

Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements. A material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interm financial statements will not be prevented or detected.

Specifically, the material weakness identified by the Company related to control and monitoring of its regional and site car wash management personnel for compliance with the Company's field policies and procedures for hiring and terminating car wash site employees, and the maintenance of personnel files located at the car wash locations. Management determined that the material weakness did not have a financial statement impact.

Changes in Internal Control Over Financial Reporting and Remediation Actions

In March 2006, we began the remediation of the material weakness in our internal control over financial reporting relating to the hiring and termination policies and procedures for car wash field personnel through: (i) the hiring of a Human Resource Manager to focus on training, monitoring, and enforcement of field hiring and termination policies and procedures; (ii) enhancements to current regional management monitoring and testing for adherence to field policies and control procedures by field car wash management; (iii) the addition of certain corporate level quarterly testing and monitoring procedures of regional and field car wash management for adherence to policies and procedures; and (iv) enhancements to car wash personnel files maintenance procedures. We will continue to closely monitor the effectiveness of our processes, procedures and controls, and will make further changes as management determines appropriate.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Name	Age	Position
Louis D. Paolino, Jr.	50	Chairman of the Board, President, and Chief Executive Officer
Robert M. Kramer	53	Executive Vice President, Chief Operating Officer of the Car and Truck Wash Segment,General Counsel and Secretary
Gregory M. Krzemien	46	Chief Financial Officer and Treasurer
Ronald R. Pirollo	47	Chief Accounting Officer and Corporate Controller
Matthew J. Paolino	41	Director, Vice President
Mark S. Alsentzer	51	Director
Constantine N. Papadakis, Ph.D.	60	Director
Burton Segal	62	Director

All of the Mace's directors serve for terms of one year each until their successors are elected and qualified.

Louis D. Paolino, Jr. has served as the Chairman of the Board, President and Chief Executive Officer of the Company since May 1999. From June 1996 through December 1998, Mr. Paolino served as Chairman of the Board, President and Chief Executive Officer of Eastern Environmental Services, Inc. Prior thereto, he was President of Soil Remediation of Philadelphia, Inc., a company engaged in the business of treating contaminated soil. From September 1993 to June 1996, Mr. Paolino served as a Vice President of USA Waste Services, Inc. From November 1995 to January 1996, Mr. Paolino served on the Board of Directors of Metal Management, Inc., formerly known as General Parametrics Corp., a publicly traded company. Mr. Paolino received a B.S. in Civil Engineering from Drexel University. Mr. Paolino is the brother of Matthew J. Paolino.

Robert M. Kramer has served as Executive Vice President, General Counsel, and Secretary of the Company since May 1999, and as Chief Operating Officer of the Car and Truck Wash Segment since July 2000. Mr. Kramer also served as a director of the Company from May 1999 to December 2003. From June 1996 through December 1998, he served as General Counsel, Executive Vice President and Secretary of Eastern Environmental Services, Inc. Mr. Kramer is an attorney and has practiced law since 1979 with various firms, including Blank Rome Comisky & McCauley, Philadelphia, Pennsylvania and Arent Fox Kitner Poltkin & Kahn, Washington, D.C. From 1989 to December 2000, Mr. Kramer had been the sole partner of Robert M. Kramer & Associates, P.C.. From December 1989 to December 1997, Mr. Kramer served on the Board of Directors of American Capital Corporation, a registered securities broker dealer. Mr. Kramer received B.S. and J.D. degrees from Temple University.

Gregory M. Krzemien has served as the Chief Financial Officer and Treasurer of the Company since May 1999. From August 1992 through December 1998, he served as Chief Financial Officer and Treasurer of Eastern Environmental Services, Inc. From October 1988 to August 1992, Mr. Krzemien was a senior audit manager with Ernst & Young LLP. Mr. Krzemien received a B.S. degree in Accounting from the Pennsylvania State University and is a certified public accountant.

Ronald R. Pirollo has served as Chief Accounting Officer and Corporate Controller of the Company since May 1999. Mr. Pirollo served as Vice President and Corporate Controller of Eastern Environmental Services, Inc. from July 1997 to June 1999. Prior thereto, Mr. Pirollo was with Envirite Corporation for ten years, where he served in various financial management positions including Vice President - Finance. Mr. Pirollo received a B.S. degree in Accounting and an MBA from Villanova University.

Matthew J. Paolino has served as a director and as a Vice President of the Company since May 1999. From 1996 to December 1998, Mr. Paolino served as a director of Eastern Environmental Services, Inc. as well as Vice President of Risk Management, Asset Management and Special Waste Divisions of Eastern Environmental Services, Inc. From 1993 to 1996, Mr. Paolino served as Vice President and General Manager - Soil Remediation Division of USA Waste Services, Inc., which was acquired by Eastern in August 1997. Mr. Paolino received a B.S. degree in Civil Engineering from Villanova University in 1986 and a J.D. degree from the Widener School of Law in 1994. Mr. Paolino is the brother of Louis D. Paolino, Jr., the Chairman, President and Chief Executive Officer of the Company.

Mark S. Alsentzer has served as a director of the Company since December 1999. From December 1996 through September 2004, Mr. Alsentzer was President and Chief Executive Officer of U.S. Plastic Lumber Corporation (a plastic and lumber and recycling company). From 1992 to December 1996, Mr. Alsentzer served as Vice President of Republic Environmental Systems, Inc. (an environmental services company). Mr. Alsentzer also served as a director, and from January 4, 2000, as Chairman of the Board, of U.S. Plastic Lumber Corporation. On July 23, 2004, U.S. Plastic Lumber Corporation filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. At the time of the Chapter 11 filing, Mark S. Alsentzer was Chairman, President and Chief Executive Officer of U.S. Plastic Lumber Corporation. Mr. Alsentzer resigned as a director on the Board of U.S. Plastic Lumber Corporation in October 2005 and is no longer Chairman, President or Chief Executive Officer. Since January 2006, Mr. Alsentzer serves as the Chief Executive Officer and a director of Pure Earth, Inc.

Constantine N. Papadakis, Ph.D. has served as a director of the Company since May 1999. From 1995 through the present, Dr. Papadakis has been President of Drexel University. From 1986 through 1995, Dr. Papadakis was Dean of the College of Engineering, Geier Professor of Engineering Education and Professor of Civil Engineering at the University of Cincinnati. Dr. Papadakis also serves on the board of directors of Sovereign Bank, Met-Pro Corporation, The Philadelphia Stock Exchange, Corcell, Inc., the Judicial Council of the Supreme Court of Pennsylvania, the Opera Company of Philadelphia, the National Commission for Cooperative Education, the University City Science Center, the Ben Franklin Technology Center and the World Trade Center of Greater Philadelphia.

Burton Segal has served as a director of the Company since December 2003. From 1973 through May 31, 2005, Mr. Segal has been a Principal in the accounting firm of Burton Segal & Company, Certified Public Accountants, and from June 1, 2005 through the present in the accounting firm of Segal, Brint & Company, LLC.

Independence

The Board has determined that the Messrs. Alsentzer, Papadakis and Segal are independent directors within the meaning of Rule 4200 (a) (15) of National Association of Securities Dealers' Nasdaq National Market listing standards.

Audit Committee Financial Expert

The Board of Directors has determined that Burton Segal, the Chairman of the Company's Audit Committee, is an audit committee financial expert as defined by Item 401(h) of Regulation S-K of the Exchange Act.

Audit Committee

The Company has a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The members of the Audit Committee are Burton Segal, Chairman, Mark S. Alsentzer, and Constantine N. Papadakis, Ph.D. The Board of Directors has determined that each member of the Audit Committee is independent within the meaning of Rule 4200(a)(15) of the National Association of Securities Dealers' Nasdaq National Market listing standards and Rule 10A-3 promulgated under the Securities Exchange Act of 1934.

Code of Ethics and Corporate Governance

The Company has adopted a Code of Ethics and Business Conduct for directors, officers (including the chief executive officer, chief financial officer, and chief accounting officer), and employees. The Code of Ethics and Business Conduct is posted on our website at www.mace.com.

The Board of Directors adopted Corporate Governance Guidelines. Stockholders are encouraged to review the Corporate Governance Guidelines at our website at www.mace.com for information concerning the Company's governance practices. Copies of the charters of the committees of the Board are also available on the Company's website.

Section 16(a) Beneficial Ownership Reporting Compliance.

Section 16(a) of the Exchange Act requires Mace's directors and executive officers, as well as persons beneficially owning more than 10% of Mace's outstanding shares of common stock and certain other holders of such shares (collectively, "Covered Persons"), to file with the Commission and the Nasdaq Stock Market (the "Nasdaq"), within specified time periods, initial reports of ownership, and subsequent reports of changes in ownership, of common stock and other equity securities of Mace. Based upon Mace's review of copies of such reports furnished to it and upon representations of Covered Persons that no other reports were required, to Mace's knowledge, all of the Section 16(a) filings required to be made by the Covered Persons with respect to 2005 were made on a timely basis.

ITEM 11. EXECUTIVE COMPENSATION

The following table provides summary information concerning cash and certain other compensation paid or accrued by Mace to or on behalf of Mace's Chief Executive Officer and each of the other most highly compensated executive officers of Mace whose compensation exceeded $100,000 (the "Named Executive Officers") for the three years ended December 31, 2005.

SUMMARY COMPENSATION TABLE(1)

NAME AND PRINCIPAL POSITIONS	Fiscal Year ended December 31,	Annual Compensation Salary	Annual Compensation Bonus	Long-Term Compensation Awards Securities Underlying Options
Louis D. Paolino, Jr.	2005	$400,000	-	15,000
Chairman of the Board, President	2004	$400,000	$200,000	732,182
and Chief Executive Officer	2003	$346,769	-	150,000
Robert M. Kramer	2005	$210,000	-	-
Executive Vice President,	2004	$163,438	-	112,500
Chief Operating Officer of the	2003	$155,692	-	150,000
Car and Truck Wash Segment,				
General Counsel and Secretary				
Gregory M. Krzemien	2005	$200,000	-	-
Chief Financial Officer and Treasurer	2004	$144,485	-	50,000
	2003	$135,492	-	150,000
Ronald R. Pirollo	2005	$164,123	-	-
Chief Accounting Officer	2004	$130,137		25,000
and Corporate Controller	2003	$118,427		100,000

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(1) The columns captioned “Annual Compensation - Other Annual Compensation,” “Long-Term Compensation - Restricted Stock Awards,” “LTIP Payouts,” and “All Other Compensation” have been omitted because none of the Named Executive Officers received other annual compensation except for Mr. Paolino who receives a car at a lease cost of $1,500 per month. Additionally, the Company paid legal fees in 2004 to Mr. Paolino’s attorney of approximately $38,800 which were incurred in connection with Mr. Paolino’s obligation to file Forms 4 and Schedules D in connection with his ownership of the Company’s common stock. The Company (i) granted no restricted stock awards, and (ii) maintained no long-term incentive plan for any of the Named Executive Officers, in each case during the three fiscal years ended December 31, 2005. Additionally, the Company has not issued any stock appreciation rights (SARs) in any of the past three years.

Director Compensation

Prior to June 30, 2004, Mace did not pay fees to directors, but paid non-employee directors reasonable travel and out-of-pocket expenses relating to their attendance at meetings. On June 29, 2004, the Independent Directors approved a compensation package for the Independent Directors consisting of (a) an annual fee of $4,000, prorated for partial years of service, (b) a $750 fee for in-person attendance at each Board meeting, and (c) a $300 fee for in-person attendance at each committee meeting. On October 6, 2005, the Independent Directors approved an update to the Independent Directors compensation consisting of an annual fee of $10,000 for 2006 services, prorated for partial years of service, and a $1,000 per day meeting fee for physical attendance at Board of Director and related Committee meetings.

On October 6, 2005, Mace’s directors, Louis D. Paolino, Jr., Matthew J. Paolino, Mark S. Alsentzer, Burton Segal, and Constantine N. Papadakis, Ph.D., were each granted options to purchase 15,000 shares of Mace common stock at $2.64 per share for their service on the Board of Directors in 2005.

On August 10, 2004, Mace’s then current outside directors, Mark S. Alsentzer, Burton Segal, and Constantine N. Papadakis, Ph.D., were each granted options to purchase 11,000 shares of Mace common stock at $3.04 per share for their service on the Board of Directors in 2004. Additionally, on November 2, 2004, Mark S. Alsentzer was granted options to purchase 25,000 shares of Mace common stock at $5.00 per share to compensate him for not being able to exercise a warrant for 25,000 shares prior to expiration due to the Company’s insider trading policy. On November 19, 2004, Louis D. Paolino, Jr., Matthew J. Paolino, Mark S. Alsentzer, Burton Segal, and Constantine N. Papadakis, Ph.D., were each granted options to purcahse 14,000 shares of Mace common stock at $5.35 per share for their services on the Board of Directors in 2004.

On April 4, 2002, Mace’s then current outside directors, Richard B. Muir, Mark S. Alsentzer and Constantine N. Papadakis, Ph.D., were each granted options to purchase 12,500 shares of Mace common stock at $2.36 per share for their service on the Board of Directors in 2002.

All of the above grants were made under the 1999 Stock Option Plan.

Equity Compensation Plan Information

Stock options are issued under the 1999 Stock Option Plan at the discretion of the Compensation Committee to employees at an exercise price of no less than the then current market price of the common stock and generally expire ten years from the date of grant. Allocation of available options and vesting schedules are at the discretion of the Compensation Committee and are determined by potential contribution to, or impact upon, the overall performance of the Company by the executives and employees. Stock options are also issued to members of the Board of Directors at the discretion of the Compensation Committee. These options may have similar terms as those issued to officers or may vest immediately. The purpose of the Stock Option Plan, which has been approved by the stockholders of the Company, is to provide a means of performance-based compensation in order to provide incentive for the Company’s employees. Warrants have been issued in connection with the sale of the shares of the Company’s stock, the purchase and sale of certain businesses and to a director. The terms of the warrants have been established by the Board of Directors of the Company. Certain of the warrants have been approved by stockholders.

The following table sets forth certain information regarding the Company's Stock Option Plan and warrants as of December 31, 2005.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights		(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	3,108,682	$	4.00	3,984,382
Equity compensation plans not approved by stockholders	433,000	$	8.02	N/A

Option and Warrant Grants in Last Fiscal Year

The following table sets forth certain information concerning individual grants of stock options to the Named Executive Officers during the fiscal year ended December 31, 2005.

OPTION GRANTS IN LAST FISCAL YEAR (1)
(Individual Grants)

Name	Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year (1)		Exercise Price Per Share($)	Expiration Date	Potential Realizable Value at Assumed Rates of Stock Price Appreciation for Option Term			
							5%		10%
Louis D. Paolino, Jr.	15,000	5.0%	$	2.64	10/31/15	$	24,900	$	63,150

(1) The Company granted options to employees and directors to purchase a total 300,000 shares of common stock during the fiscal year ended December 31, 2005. All of these grants were made at exercise prices equal to the fair market value of the common stock at the date of grant.

Aggregated Option and Warrant Exercises in Last Fiscal Year

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The following table sets forth certain information regarding stock options held by the Named Executive Officers during the fiscal year ended December 31, 2005, including the number and value of exercisable and unexercisable stock options as of December 31, 2005. No options were exercised by any of the Named Executive Officers during the fiscal year ended December 31, 2005. In-the-money options are those for which the fair market value of the underlying securities exceeds the exercise price of the option. The closing transaction price of the Company's common stock on December 31, 2005 was $2.47 per share.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND YEAR-END OPTION VALUES

	Number of Securities Underlying Unexercised Options at Fiscal Year End 2005		Value of Unexercised In-the-money Options/SARs at Fiscal Year End 2005	
Name	**Exercisable**	**Unexercisable**	**Exercisable**	**Unexercisable**
Louis D. Paolino, Jr.	989,682	-	$ 182,215	$ -
Gregory M. Krzemien	350,000	-	$ 231,375	$ -
Robert M. Kramer	455,000	-	$ 231,375	$ -
Ronald R. Pirollo	200,000	-	$ 112,500	$ -

Employment Agreements

Louis D. Paolino, Jr., Employment Agreement

Mace currently employs Louis D. Paolino, Jr., as its President and Chief Executive Officer under a three-year employment agreement dated August 12, 2003. The principal terms of the employment agreement include: annual salary of $400,000; a car allowance not to exceed $1,500 per month; provision of certain medical and other employee benefits; prohibition against competing with Mace during employment and for a three-month period following a termination of employment; and a $2.5 million payment in the event that Mr. Paolino's employment is terminated for certain reasons set forth in the employment agreement. The termination payment is not due in the event of termination due to death or disability or certain prohibited conduct, as more fully set forth in the employment agreement. The termination payment is due if Mr. Paolino is terminated for unsatisfactory job performance. The employment agreement also entitles Mr. Paolino to a $2.5 million change-of-control bonus.

Other Executive Employment Agreements

The primary terms of the employment agreements for Robert M. Kramer, Gregory M. Krzemien, and Ronald R. Pirollo expired on March 26, 2003. Messrs. Kramer and Krzemien are working on a month-to-month, at-will basis under the provisions of their employment agreements. Mr. Pirollo or the Company may terminate Mr. Pirollo's employment at any time. Under the employment agreements, Mace granted in 1999 to each of these executive officers options to purchase shares of Mace common stock at $5.375 per share that vested over a period of four years. The table below discloses the current salary and initial option grants for these executive officers.

Name	Office	Current Annual Salary	Initial Option Grant
Robert M. Kramer	Chief Operating Officer of the Car and Truck Wash Segment, Executive Vice President, General Counsel and Secretary	$210,000	100,000
Gregory M. Krzemien	Chief Financial Officer	$200,000	62,500

	and Treasurer		
Ronald R. Pirollo	Chief Accounting Officer and Corporate Controller	$160,000	25,000

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Compensation Committee Interlocks and Insider Participation

The Compensation Committee of the Company's Board of Directors consisted of directors Burton Segal, Mark Alsentzer, and Constantine N. Papadakis, Ph.D. No executive officer of Mace served as a director or compensation committee member of any entity of which Messrs. Segal, Alsentzer or Papadakis was an executive officer or director.

Compensation Committee Report on Executive Compensation

The Compensation Committee of the Company's Board of Directors consists of directors Burton Segal, Mark Alentzer, and Constantine N. Papadakis, Ph.D, all of whom the Board has determined are independent pursuant to the NASD's Nasdaq National Market Marketplace Rules. This report shall not be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended (the "Securities Act"), or the Securities Exchange Act of 1934, as amended (the "Exchange Act"), by virtue of any general statement in such filing incorporating this Form 10-K by reference, except to the extent that the Company specifically incorporates the information contained in this section by reference, and shall not otherwise be deemed filed under either the Securities Act or the Exchange Act.

General. The Committee is responsible for matters related to compensation, including compensation policy and the review and approval, or recommendation to the Board for approval, of salaries, bonus and other compensation of the Company's officers. The Company's compensation policies for executives are intended to further the interests of the Company and its stockholders by encouraging growth of its business through securing, retaining, and motivating management employees of high caliber who possess the skills necessary for the development and growth of the Company.

Components of Executive Compensation

The Company's current compensation package consists of three components: base salaries, bonuses and stock options. Together, these elements comprise total compensation value. In determining specific levels of compensation for the Company's executives, the Committee considers the achievement of corporate and individual goals, financial performance of the Company, recommendations of management and benchmarks provided by comparative data of peer companies. The Committee seeks to ensure that the appropriate relationship exists between executive compensation and corporate performance. In addition, the total compensation paid to the Company's executive officers is influenced significantly by the need (i) to attract management employees with a high level of expertise, and (ii) to motivate and retain key executives for the long-term success of the Company and its stockholders.

Base Compensation. In setting and adjusting base salary levels for each individual executive, the Compensation Committee considers factors such as the executive's scope of responsibility, the executive's performance, the performance of the Company, future potential and benchmarks of comparable positions at other companies. In making salary decisions, the Compensation Committee exercises subjective judgement using no specific weights for the previously discussed factors. In setting 2004 base salaries of executives other than the Chief Executive Officer, the Committee has attempted to keep base salaries as low as possible while still retaining its executives. Comparative data provided by Amper, Politziner and Mattia, P.C. reflects that base cash compensation levels are near the 25th percentile of peer companies surveyed for Mr. Kramer, Mr. Krzemien and Mr. Pirollo. Peer companies included companies providing consumer services on a national basis. For 2005, the Committee maintained the same annual base salary levels for its executives as in 2004. In reviewing the base salaries of the Company's executive officers for 2005, the Committee considered the individual performance of each executive, the Company's financial performance in 2005, management's efforts to maximize operating profits from its Car and Truck Wash Segment, the Company's goal to sell its car and truck washes, the continuing growth of its Security Segment, and keeping the Company's overhead as low as possible.

Stock Options. The Company grants stock options to its executive management under its 1999 employee stock option plan. Option grants are intended to offer significant returns if the Company is successful and, therefore, create significant incentives to devote the effort called for in order to implement the Company's strategic plan. The Compensation Committee believes that executives' interests are directly tied to enhanced stockholder value. Thus, stock options are used to provide the executive management team with a strong incentive to perform in a manner that should result in the long-term success of the Company. The Compensation Committee authorized stock options for Mr. Kramer, Mr. Krzemien and Mr. Pirollo on March 1, 2006 as incentive compensation for their 2005 performance in the respective amounts of 75,000, 60,000 and 25,000. All awarded options had an exercise price of $2.40, the close of market on March 1, 2006. The options were issued on March 23, 2006. The options awarded to the Executive Officers vest one third upon issuance, one third twelve months from issuance and one third twenty-four months from issuance.

Performance Bonuses. The Company maintains the option to supplement base compensation with awards of performance bonuses in the form of cash to reward efforts undertaken by its key executive officers which are extraordinary in nature. No discretionary bonuses were paid to executive officers for 2005.

Compensation of the Chief Executive Officer

The compensation of Louis D. Paolino, Jr., the Chief Executive Officer, for 2005 was primarily made up of base salary and stock options. Mr. Paolino's base salary was set at $400,000 in the employment agreement he entered into with the Company in August 2003. As discussed above, in 2004, the Committee reviewed comparative data provided by Amper, Politziner and Mattia, P.C. and determined that Mr., Paolino's base salary was near the median of the peer companies surveyed. Mr. Paolino's salary was not adjusted in 2004 or 2005. In addition, Mr. Paolino received 15,000 stock options in 2005 for his service on the Board of Directors. The Compensation Committee authorized Mr. Paolino to receive 150,000 stock options at an exercise price of $2.40 on March 1, 2006 for his role in the Company's performance in 2005, including overseeing progress in the Company's efforts to sell its car and truck washes and the continuing growth of its Security Segment. The options were issued on March 23, 2006.

The Compensation Committee of the Board of Directors

Burton Segal
Mark Alsentzer
Constantine N. Papadakis, Ph.D.

Stock Performance Graph

The following line graph and table compare, for the five most recently concluded fiscal years, the yearly percentage change in the cumulative total stockholder return, assuming reinvestment of dividends, on the Company's common stock with the cumulative total return of companies on the Nasdaq Stock Market and an index comprised of certain companies in similar service industries (the "Selected Peer Group Index"[(1)]). "Selected Peer Group Index")[(1)].

(1) The Selected Peer Group Index is comprised of securities of IPIX Corporation, Lo Jack Corp., Napco Security Systems Inc., Rockford Corporation, Taser International Inc., Vicon Industries Inc. There can be no assurance that the Company's stock performance will continue into the future with the same or similar trends depicted by the graph above. The Company neither makes nor endorses any predictions as to future stock performance.

(1) The Selected Peer Group Index is comprised of securities of IPIX Corporation, Lo Jack Corp., Napco Security Systems Inc., Rockford Corporation, Taser International Inc., Vicon Industries Inc. There can be no assurance that the Company's stock performance will continue into the future with the same or similar trends depicted by the graph above. The Company neither makes nor endorses any predictions as to future stock performance.

COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN AMONG MACE SECURITY INTERNATIONAL, INC., THE NASDAQ MARKET INDEX, AND SELECTED PEER GROUP

	December 31,					
	2000	2001	2002	2003	2004	2005
Mace Security International, Inc.	100.0	94.92	115.34	115.34	264.90	136.31
Selected Peer Group	100.0	86.50	71.42	126.88	317.72	253.96
Nasdaq Market Index	100.0	79.71	55.60	83.60	90.63	92.62

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The Performance Graph set forth above shall not be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act by virtue of any general statement in such filing incorporating this Form 10-K by reference, except to the extent that the Company specifically incorporates the information contained in this section by reference, and shall not otherwise be deemed filed under either the Securities Act or the Exchange Act.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Beneficial Ownership

The following beneficial ownership table sets forth information as of January 31, 2006 regarding beneficial ownership of shares of Mace common stock by the following persons:

l each person who is known to Mace to own beneficially more than 5% of the outstanding shares of Mace common stock, based upon Mace's records or the records of the United States Securities and Exchange Commission;
l each director of Mace;
l each Named Executive Officer; and
l all directors and executive officers of Mace as a group.

Unless otherwise indicated, to Mace's knowledge, all persons listed on the beneficial ownership table below have sole voting and investment power with respect to their shares of Mace common stock. Shares of Mace common stock subject to options or warrants exercisable within 60 days of January 31, 2006, are deemed outstanding for the purpose of computing the percentage ownership of the person holding such options or warrants, but are not deemed outstanding for computing the percentage ownership of any other person.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percentage of Common Stock Owned (1)
Louis D. Paolino, Jr. 1000 Crawford Place, Suite 400 Mt. Laurel, NJ 08054	1,880,640(2)	11.6%
Mark S. Alsentzer	592,500(3)	3.9
Matthew J. Paolino	298,354(4)	1.9
Robert M. Kramer	524,824(5)	3.3
Gregory M. Krzemien	375,250(6)	2.4
Ronald R. Pirollo	205,000(7)	1.3
Constantine N. Papadakis, Ph.D.	87,500(8)	*
Burton Segal	40,000(9)	*
All current directors and executive officers as a group (8 persons)	4,004,068(10)	22.8%

* Less than 1% of the outstanding shares of Mace common stock.

(1) Percentage calculation is based on 15,272,882 shares outstanding on January 31, 2006.
(2) Includes options to purchase 989,682 shares.
(3) Includes options to purchase 92,500 shares.

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(4)	Includes options to purchase 96,500 shares.
(5)	Includes options to purchase 455,000 shares.
(6)	Includes options to purchase 350,000 shares.
(7)	Includes options to purchase 200,000 shares.
(8)	Represents options to purchase 87,500 shares.
(9)	Represents options to purchase 40,000 shares.
(10)	See Notes 2 through 9 above.

Equity Compensation Plan Information

See the information contained under the heading "Equity Compensation Plan Information" within Item 11 of this Form 10-K regarding shares authorized for issuance under equity compensation plans approved by stockholders and not approved by stockholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Certain Relationships and Related Party Transactions

From November, 2001 through July 2002, the Company prepaid LP Learjets, LLC $5,109 per month for the right to use a Learjet 31A for 100 hours per year. LP Learjets, LLC is a company owned by Louis D. Paolino, Jr., the Company's Chairman, Chief Executive Officer and President. When the Learjet 31A is used, the prepaid amount is reduced by the hourly usage charge as approved by the Audit Committee, and the Company pays to third parties unaffiliated with Louis D. Paolino, Jr., the direct costs of the Learjet's per-hour use, which include fuel, pilot fees, engine insurance and landing fees. The balance of unused prepaid flight fees totaled $31,659 at December 31, 2005.

Louis D. Paolino, Jr. purchased approximately $44,600 and $20,600 of the Company's products in fiscal 2005 and 2004, respectively, at a discount from the prices charged to distributors. The total of the discount given to Mr. Paolino was approximately $18,300 and $6,600 in fiscal 2005 and 2004, respectively.

The Company's Security Segment leases manufacturing and office space under a five-year lease with Vermont Mill, Inc. ("Vermont Mill"), which provided for monthly lease payments of $9,167 through November 2004. Vermont Mill is controlled by Jon E. Goodrich, a former director and current employee of the Company. The Company has exercised an option to continue the lease through November 2009 at a rate of $10,576 per month. The Company believes that the lease rate is lower than lease rates charged for similar properties in the Bennington, Vermont area. On July 22, 2002, the lease was amended to provide Mace the option and right to cancel the lease with proper notice and a payment equal to six months of the then current rent for the leased space occupied by Mace. Rent expense under this lease was $126,000, $111,000 and $110,000 for 2005, 2004, and 2003, respectively.

From January 1, 2004 through December 31, 2005, the Company's Security Segment sold approximately $146,300 of electronic security equipment to two companies, each of which Louis Paolino, III, the son of the Company's CEO, Louis D. Paolino, Jr., is a partial owner. The pricing extended to these companies is no more favorable than the pricing given to third party customers who purchase in similar volume. At December 31, 2005, $13,529 was owed from one of these companies to Mace.

On September 29, 2005, Louis Paolino III, the son of the Company's Chief Executive Officer, Louis Paolino, Jr., purchased from the Company a warehouse bay in Hollywood, Florida that is no longer used in the Company's operations for $306,000 in cash. The Company's Audit Committee authorized the Company on February 14, 2005 to proceed with a sale of the warehouse property to Louis Paolino III for $306,000. The Company paid $256,688 for the property in 2003. The warehouse property was appraised by a third party independent appraiser on January 18, 2005 at an estimated market value of $306,000.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Audit Fees. The Company was billed $384,050 through May 31, 2006, by Grant Thornton LLP for the audit of Mace's annual financial statements for the fiscal year ended December 31, 2005, and for the review of the financial statements included in Mace's Quarterly Reports on Forms 10-Q filed during 2005. The Company was billed $184,201 by Grant Thornton LLP for the audit of Mace's annual financial statements for the fiscal year ended December 31, 2004, and for the review of the financial statements included in Mace's Quarterly Reports on Forms 10-Q filed during 2004.

Audit Related Fees. The Company did not incur any audit related fees during 2005 or 2004.

Tax Fees. The Company was billed $50,463 and $17,684 for tax compliance services rendered by Grant Thornton LLP during 2005 and 2004, respectively.

All Other Fees. Mace was billed $46,788 for non-audit or non-tax services, rendered by Grant Thornton LLP during 2004. There were no other fees in 2005.

Other Matters. The Audit Committee of the Board of Directors has considered whether the provision of financial information systems design and implementation services and other non-audit services is compatible with maintaining the independence of Mace's independent auditors, Grant Thornton LLP. The Audit Committee pre-approves all auditing services and permitted non-audit services (including the fees and terms thereof) to be performed for the Company by its independent auditors. All auditing services and permitted non-audit services in 2004 and 2005 were preapproved. The Audit Committee may delegate authority to the chairman, or in his or her absence, a member designated by the chairmen to grant pre-approvals of audit and permitted non-audit services, provided that decisions of such person or subcommittee to grant pre-approvals shall be presented to the full Audit Committee at its next scheduled meeting.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1)	Consolidated Financial Statements: Report of Independent Registered Public Accounting Firm Consolidated Balance Sheets as of December 31, 2005 and 2004 Consolidated Statements of Operations for the years ended December 31, 2005, 2004, and 2003 Consolidated Statements of Stockholders' Equity for the years ended December 31, 2005, 2004, and 2003 Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004, and 2003 Notes to Consolidated Financial Statements
(a) (2)	The requirements of Schedule II have been included in the Notes to Consolidated Financial Statements. All other schedules for which provision is made in the applicable accounting regulations of the United States Securities and Exchange Commission ("the Commission") are not required under the related instructions or are inapplicable, and therefore, have been omitted.

(a) (3) Exhibits:

The following Exhibits are filed as part of this report (exhibits marked with an asterisk have been previously filed with the Commission and are incorporated herein by this reference):

* 2.1	Asset Purchase Agreement dated February 28, 2006, between Mace Security International, Inc., Mace Car Wash, Inc., Mace Car Wash-Arizona, Inc., and CW Acquisition, LLC. (Exhibit 10.1 to the February 28, 2006 Form 8-K filed March 6, 2006.)
*3.3	Amended and Restated Bylaws of Mace Security International, Inc. (Exhibit 3.3 to the Company's Report on Form 10-KSB for the year ended December 31, 1999 (the "1999 Form 10-KSB"))
*3.4	Amended and Restated Certificate of Incorporation of Mace Security International, Inc. (Exhibit 3.4 to the 1999 Form 10-KSB)
*3.5	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Mace Security International, Inc. (Exhibit 3.5 to the 2000 Form 10-KSB)
*3.6	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Mace Security International, Inc. (Exhibit 3.6 to the 2002 Form 10-K)
*3.7	The Company's Amended and Restated Certificate of Incorporation (Exhibit 4.1 to the June 16, 2004 Form S-3)
*10.3	1993 Non-Qualified Stock Option Plan (1) (3)
*10.22	Trademarks(1)
*10.28	Warrants in connection with the acquisition of the assets of the KinderGard Corporation(2)
*10.71	Employment Contract between Mace Security International, Inc. and Robert M. Kramer dated March 26, 1999 (3)
*10.72	Employment Contract between Mace Security International, Inc. and Gregory M. Krzemien dated March 26, 1999 (3)
*10.73	Amendment No. 1 to Merger Agreement between Louis D. Paolino, Red Mountain Holding, Ltd. and Mace Security International, Inc. dated April 13, 1999
*10.74	Amendment No. 1 to Stock purchase Agreement, between Louis Paolino, Jr. and Mace Security International, Inc. dated April 13, 1999
*10.98	Mace Security International, Inc. 1999 Stock Option Plan (3).(Exhibit 10.98 to the June 30, 1999 Form 10-QSB dated August 13, 1999)

*10.123	Loan Agreement and Promissory Note dated February 17, 2000, between the Company, its subsidiary Mace Car Wash - Arizona, Inc. and Bank One, Texas, NA. (Exhibit 10.123 to the December 31, 1999 Form 10-KSB dated March 29, 2000)
*10.124	Business Loan Agreement dated January 31, 2000, between the Company, its subsidiary - Colonial Full Service Car Wash, Inc., and Bank One, Texas, N.A.; Promissory Note dated February 2, 2000 between the same parties as above in the amount of $400,000 (pursuant to instruction 2 to Item 601 of Regulation S-K, two additional Promissory Notes, which are substantially identical in all material respects except as to the amount of the Promissory Notes) are not being filed in the amount of: $19,643.97 and $6,482; and a Modification Agreement dated as of January 31, 2000 between the same parties as above in the amount of $110,801.55 (pursuant to instruction 2 to Item 601 of Regulation S-K, Modification Agreements, which are substantially identical in all material respects except to the amount of the Modification Agreement) are not being filed in the amounts of: $39,617.29, $1,947,884.87, $853,745.73, and $1,696,103.31.(Exhibit 10.124 to the December 31, 1999 Form 10-KSB dated March 29, 2000)

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*10.128	Form of Equity Purchase Agreement to be issued by Mace to Fusion Capital (included as Exhibit A to Master Facility Agreement in Exhibit 10.1 of S-3). (Exhibit 4.1 to the Company's Current Form on S-3 dated April 11, 2000).
*10.129	Master Facility Agreement, dated as of April 5, 2000, between Mace and Fusion Capital (Exhibit 10.1 to the Company's Current Form on S-3 dated April 11, 2000).
*10.130	Loan Agreement and Promissory Note dated November 28, 2000, between the Company, its subsidiary Eager Beaver Car Wash, Inc. and Bank One, Texas, N.A. in the amount of $6,754,400. (Exhibit 10.130 to the December 31, 2000 Form 10-KSB dated March 20, 2001)
*10.131	Lease Agreement dated August 1, 2000 among Mace Security International, Inc. and Bluepointe, Inc. (Exhibit 10.131 to the December 31, 2000 Form 10-KSB dated March 20, 2001)
*10.132	Amendment dated March 13, 2001, to Business Loan Agreement between the Company, its subsidiary Colonial Full Service Car Wash, Inc., and Bank One, Texas, N.A. (pursuant to instruction 2 to Item 601 of Regulation S-K, two additional amendments which are substantially identical in all material respects, except as to the borrower being Eager Beaver Car Wash, Inc. and Mace Car Wash - Arizona, Inc., are not being filed).(Exhibit 10.132 to the December 31, 2000 Form 10-KSB dated March 20, 2001)
*10.133	Modification Agreement between the Company, its subsidiary - Colonial Full Service Car Wash, Inc., and Bank One, Texas, N.A. in the amount of $2,216,000 (pursuant to Instruction 2 to Item 601 of Regulation S-K, Modification Agreements, which are substantially identical in all material respects except to amount and extension date of the Modification Agreement are not being filed in the original amounts of $984,000 (extended to August 20, 2004) and $1,970,000 (extended to June 21, 2004).(Exhibit 10.133 to the June 30, 2001 Form 10-Q dated August 9, 2001)
*10.134	Term Note dated November 6, 2001, between the Company, its subsidiary, Colonial Full Service Car Wash, Inc., and Bank One, Texas, N.A. in the amount of $380,000.(Exhibit 10.134 to the September 30, 2001 Form 10-Q dated November 9, 2001)
*10.135	Amendment dated February 21, 2002 to Management Agreement between the Company and Mark Sport, Inc. and original Management Agreement dated February 1, 2000 to which the amendment relates.(Exhibit 10.135 to the December 31, 2001 Form 10-K dated March 11, 2002)
*10.136	Amendment dated February 25, 2002 to Lease Agreement between the Company and Vermont Mill Properties, Inc. and original Lease Agreement dated November 15, 1999 to which the amendment relates.(Exhibit 10.136 to the December 31, 2001 Form 10-K dated March 11, 2002)
*10.137	Promissory Note between the Company and Vermont Mill Properties, Inc. dated February 22, 2002 in the amount of $228,671. (Exhibit 10.137 to the December 31, 2001 Form 10-K dated March 11, 2002)
*10.138	Extension dated February 6, 2002 of Equity Purchase Agreement between the Company and Fusion Capital Fund II, LLC. (Exhibit 10.138 to the December 31, 2001 Form 10-K dated March 11, 2002)
*10.139	Term note dated April 30, 2002, between the Company, its subsidiary, Mace Truck Wash, Inc., and Bank One, Texas, N.A. in the amount of $342,000.(Exhibit 10.139 to the June 30, 2002 Form 10-Q dated August 14, 2002)
*10.140	Master Lease Agreement dated June 10, 2002, between the Company, its subsidiary, Colonial Full Service Car Wash, Inc., and Banc One Leasing Corporation in the amount of $193,055. (Exhibit 10.140 to the June 30, 2002 Form 10-Q dated August 14, 2002)
*10.141	Amendment dated July 22, 2002 to Management Agreement between the Company and Mark Sport, Inc. (Exhibit 10.141 to the June 30, 2002 Form 10-Q dated August 14, 2002)
*10.142	Amendment dated July 22, 2002 to Lease Agreement between the Company and Vermont Mill Properties, Inc. (Exhibit 10.142 to the June 30, 2002 Form 10-Q dated August 14, 2002)
*10.143	Asset Purchase Agreement dated as of August 12, 2002, by and among Micro-Tech Manufacturing, Inc. and Moshe Luski on the one hand, and Mace Security Products, Inc., a wholly owned subsidiary of Mace Security International, Inc. (Exhibit 10.143 to September 30, 2002 Form 10-Q dated November 12, 2002)

*10.144	Lease Schedule and Addendum dated August 28, 2002 in the amount of $39,434 to Master Lease Agreement dated June 10, 2002, between the Company, its subsidiary, Colonial Full Service Car Wash, Inc., and Banc One Leasing Corporation. (Exhibit 10.144 to the September 30, 2002 Form 10-Q dated November 12, 2002)
*10.145	Promissory Note and Loan Agreement dated October 31, 2002 between the Company, its subsidiary, Mace Security Products, Inc. and Wachovia Bank, N.A. in the amount of $480,000.(Exhibit 10.145 to the December 31, 2002 Form 10-K dated March 19, 2003)
*10.146	Line of Credit Note and Credit Agreement dated December 15, 2002 between the Company, its subsidiary, Mace Security Products, Inc. and Bank One Texas, N.A. in the amount of $500,000. (Exhibit 10.146 to the December 31, 2002 Form 10-K dated March 19, 2003)

*10.147	Amendment dated February 21, 2003 to Business Loan Agreement between the Company, its subsidiary, Eager Beaver Car Wash, Inc., and Bank One, Texas, N.A. (pursuant to instruction 2 to Item 601 of Regulation S-K, two additional amendments which are substantially identical in all material respects, except as to the borrower being Mace Truck Wash, Inc. and Mace Security Products, Inc., are not being filed). (Exhibit 10.147 to the December 31, 2002 Form 10-K dated March 19, 2003)
*10.148	Note Modification Agreement dated February 21, 2003, between the Company, its subsidiary, Colonial Full Service Car Wash, Inc. and Bank One, Texas, N.A. in the amount of $348,100. (Exhibit 10.148 to the December 31, 2002 Form 10-K dated March 19, 2003)
*10.149	Note Modification Agreement dated February 21, 2003, between the Company, its subsidiary, Mace Car Wash - Arizona, Inc. and Bank One, Texas, N.A. in the amount of $4,281,578.(Exhibit 10.149 to the December 31, 2002 Form 10-K dated March 19, 2003)
*10.150	Modification Agreement dated March 14, 2003, between the Company, its subsidiary, Mace Security Products, Inc. and Wachovia Bank, N.A. (Exhibit 10.150 to the December 31, 2002 Form 10-K dated March 19, 2003)
*10.151	Note Modification Agreement dated August 5, 2003, effective July 10, 2003, between the Company, its subsidiary, Mace Car Wash - Arizona, Inc. and Bank One, Texas, N.A. in the amount of $731,455. (Exhibit 10.151 to the June 30, 2003 Form 10-Q dated August 12, 2003)
*10.152	Employment Contract dated August 12, 2003, between Mace Security International, Inc. and Louis D. Paolino, Jr. (Exhibit 10.152 to the June 30, 2003 Form 10-Q dated August 12, 2003) (3)
*10.153	Consolidated Promissory Note and Amended and Restated Loan Agreement dated October 20, 2003 between the Company, its wholly owned subsidiary, Mace Security Products, Inc. and Wachovia Bank, N.A. in the amount of $728,800. (Exhibit 10.153 to the September 30, 2003 Form 10-Q dated November 12, 2003)
*10.154	Amendment dated October 25, 2003 to Employment Contract dated August 12, 2003 by and between Mace Security International, Inc. and Louis D. Paolino, Jr. (Exhibit 10.154 to the September 30, 2003 Form 10-Q dated November 12, 2003) (3)
*10.155	Modification and Extension of Note and Ratification of Mortgage Liens dated November 28, 2003, between the Company, its subsidiary, Eager Beaver Car Wash, Inc. and Bank One, Texas, N.A. in the amount of $5,723,079. (Exhibit 10.155 to the December 31, 2004 Form 10-K dated March 12, 2004.)
*10.156	Note Modification Agreement and Amendment to Credit Agreement dated December 15, 2003, between the Company, its subsidiary, Mace Security Products, Inc. and Bank One, Texas, N.A. in the amount of $500,000.(Exhibit 10.156 to the December 31, 2004 Form 10-K dated March 12, 2004.)
*10.157	Note Modification Agreement and Amendment to Credit Agreement dated January 21, 2004, between the Company, its subsidiary, Colonial Full Service Car Wash, Inc. and Bank One, Texas, N.A. in the amount of $48,725.50.(Exhibit 10.157 to the December 31, 2004 Form 10-K dated March 12, 2004.)
*10.158	Credit Agreement dated as of December 31, 2003 between the Company, its subsidiary, Eager Beaver Car Wash, Inc., and Bank One Texas, N.A. (pursuant to instruction 2 to Item 601of Regulation S-K, four additional credit agreements which are substantially identical in all material respects, except as to the borrower being Mace Car Wash - Arizona, Inc., Colonial Full Service Car Wash, Inc., Mace Security Products, Inc. and Mace Security International, Inc., are not being filed.) (Exhibit 10.158 to the December 31, 2004 Form 10-K dated March 12, 2004.)
*10.159	Amendment to Credit Agreement dated April 27, 2004, effectiveness of March 31, 2004 between Mace Security International, Inc., and Bank One Texas, N.A. (Pursant to instruction 2 to Item 601 of Regulation S-K, four Additional credit agreements which are substantially identical in all material respects, except as to borrower being the Company's subsidiaries, Mace Car Wash-Arizona, Inc., Colonial Full Service Car Wash, Inc. Mace Security Products Inc. and Eager Beaver Car Wash, Inc., are not being filed) (Exhibit 10.159 to the March 31, 2004 Form 10-Q dated May 5, 2004)
*10.160	Termination Agreement dated April 21, 2004, between Mace Security International, Inc. and Fusion Capital Fund II, LLC. (Exhibit 10.160 to March 31, 2004 Form 10-Q dated May 5, 2004.)

*10.161	Stock Restriction Removal Agreement dated April 12, 2004, between Mace Security International, Inc. and Price Legacy Corporation (Exhibit 10.161 to the March 31, 2004 Form 10-Q dated May 5, 2004.)
*10.162	Warrant dated May 26, 2004 to purchase 183,000 shares of the Company's common stock, issued to Langley Partners, L.P. (Exhibit 4.3 to the June 16, 2004 Form S-3)
*10.163	Securities Purchase Agreement dated May 26, 2004 between the Company and Langley Partners, L.P. as set forth on the Signature pages therof (Exhibit 10.1 to the June 16, 2004 Form S-3)

*10.164	Registration Rights Agreement dated May 26, 2004 between the Company and Langley Partners, L.P. as set forth On the Signature pages thereof (Exhibit 10.2 to the June 16, 2004 Form S-3)
*10.165	First Amendment to the Securities Purchase Agreement, dated June 8, 2004 (Exhibit 10.3 to the June 16, 2004 Form S-3)
*10.166	Agreement for purchase and Sale of Assets by and among MDI Operating, L.P. America Building Control, Inc. and Mace Security International, Inc.(Exhibit 2.1 to the July 1, 2004 Form 8-K)
*10.167	Modification Agreement between the Company , its subsidiary - Colonial Full Service Car Wash, Inc., and Bank One, Texas, N.A. in the original amount of $984,000 (pursuant to Instruction 2 to Item 601 of Regulation S-K, Modification Agreements, which are substantially identical in all material respects except to amount and extension date of the Modification Agreement, are not being filed in the original amounts of $2,216,000 (extended to August 20, 2009) and $380,000 (extended to October 6, 2009)). (Exhibit 10.167 to the September 30, 2004 Form 10-Q dated November 12, 2004)
*10.168	Promissory Note dated September 15, 2004, between the Company, its subsidiary, Mace Security Products, Inc., and Bank One, Texas, N.A. in the amount of $825,000. (Exhibit 10.168 to the September 30, 2004 Form 10-Q dated November 12, 2004)
*10.169	First Amendment to Asset Purchase Agreement dated August 27, 2004, between Vernex, Inc. and Mace Security Products, Inc. (Exhibit 10.169 to the September 30, 2004 Form 10-Q dated November 12, 2004)
*10.170	Securities Purchase Agreement between Mace and Langley Partners, L.P. (Exhibit 99.2 to the December 14, 2004 Form 8-K dated December 16, 2004)
*10.171	Registration Rights Agreement between Mace and Langley Partners, L.P. (Exhibit 99.3 to the December 14, 2004 Form 8-K dated December 16, 2004)
*10.172	Warrant to be issued to Langley Partners, L.P. (Exhibit 99.4 to the December 14, 2004 Form 8-K dated December 16, 2004)
*10.174	Registration Rights Agreement between Mace and JMB Capital, L.P. (Exhibit 99.6 to the December 14, 2004 Form 8-K dated December 16, 2004)
*10.175	Warrant to be issued to JMB Capital Partners, L.P. (Exhibit 99.7 to the December 14, 2004 Form 8-K dated December 16, 2004)
10.176	Compensatory Arrangements with Certain Executive Officers and Directors. (3)
*10.177	Note Modification Agreement dated December 22, 2004 between the Company, its subsidiary, Mace Security Products Inc. and Bank One, Texas, N.A. in the amount of $500,000. (Exhibit 10.1 to the March 31, 2005 Form 10-Q dated May 10, 2005).
*10.178	Note Modification Agreement dated May 19, 2005 between the Company, its subsidiary, Mace Truck Wash, Inc. and Bank One, Texas, N.A. in the original amount of $342,000. (Exhibit 10.1 to the June 30, 2005 Form 10-Q dated August 9, 2005).
10.179	Note Modification Agreement dated December 1, 2005 between the Company, its subsidiary Mace Security Products, Inc. and JPMorgan Bank One Bank, N.A. in the amount of $500,000.
*10.180	Asset Purchase Agreement dated February 28, 2006, between Mace Security International, Inc., Mace Car Wash, Inc., Mace Car Wash-Arizona, Inc., and CW Acquisition, LLC. (Exhibit 10.1 to the February 28, 2006 Form 8-K dated March 6, 2006)
11	Statement Re: Computation of Per Share Earnings
* 14	Code of Ethics and Business Conduct (Exhibit 14 to the December 31, 2003 Form 10-K dated March 12, 2004)
21	Subsidiaries of the Company

23.1	Consent of Grant Thornton LLP
24	Power of Attorney (included on signature page)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Global Truck Wash Facility Acquisition Agreement dated December 31, 2005, between Eagle United Truck Wash, LLC and Mace Truck Wash, Inc.

* Incorporated by reference

+ Schedules and other attachments to the indicated exhibit have been omitted. The Company agrees to furnish supplementally to the Commission upon request a copy of any omitted schedules or attachments.

(1) Incorporated by reference to the exhibit of the same number filed with the Company's registration statement on Form SB-2 (33-69270) that was declared effective on November 12, 1993.

(2) Incorporated by reference to the Company's Form 10-QSB report for the quarter ended September 30, 1994 filed on November 14, 1994. It should be noted that Exhibits 10.25 through 10.34 were previously numbered 10.1 through 10.10 in that report.

(3) Indicates a management contract or compensation plan or arrangement.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MACE SECURITY INTERNATIONAL, INC.

By: /s/ Louis D. Paolino, Jr.

Louis D. Paolino, Jr.
Chairman of the Board,
Chief Executive Officer,
and President

DATED the 14th day of July, 2006

KNOW ALL MEN BY THESE PRESENTS that the undersigned does hereby constitute and appoint Louis D. Paolino, Jr. and Gregory M. Krzemien, or either of them acting alone, his true and lawful attorney-in-fact and agent, with full power of substitution and revocation for him and in his name, place and stead, in any and all capacities, to sign this Report on Form 10-K of Mace Security International, Inc. and any and all amendments to the Report and to file the same with all exhibits thereto, and other documents in connection therewith, with the United States Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or his or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated:

Name	Title	Date
/s/ Louis D. Paolino, Jr. Louis D. Paolino, Jr.	Chairman of the Board, Chief Executive Officer, President and Director (Principal Executive Officer)	7/14/06
/s/ Gregory M. Krzemien Gregory M. Krzemien	Chief Financial Officer and Treasurer (Principal Financial Officer)	7/14/06
/s/ Ronald R. Pirollo Ronald R. Pirollo	Chief Accounting Officer and Corporate Controller (Principal Accounting Officer)	7/14/06

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/s/ Matthew J. Paolino Matthew J. Paolino	Director, Vice President	7/14/06
/s/ Constantine N. Papadakis, Ph.D. Constantine N. Papadakis, Ph.D.	Director	7/14/06
/s/ Mark S. Alsentzer Mark S. Alsentzer	Director	7/14/06
/s/ Burton Segal Burton Segal	Director	7/14/06

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Mace Security International, Inc.
Audited Consolidated Financial Statements
Years ended December 31, 2005, 2004, and 2003

Contents

Report of Independent Registered Public Accounting Firm

Board of Directors
Mace Security International, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Mace Security International, Inc. and Subsidiaries as of December 31, 2005 and 2004 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mace Security International, Inc. and Subsidiaries as of December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

/s/ Grant Thornton LLP
Philadelphia, Pennsylvania
June 16, 2006 (except for Note 20 (paragraphs 5 and 6) as to which the date is July 14, 2006)

Mace Security International, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share and par value information)

ASSETS	**December 31, 2005**	**2004**
Current assets:		
Cash and cash equivalents	$ 8,360	$ 14,499
Short-term investments	3,020	-
Accounts receivable, less allowance for doubtful accounts of $593 and $449 in 2005 and 2004, respectively	2,774	2,556
Inventories	7,901	7,067
Deferred income taxes	-	321
Prepaid expenses and other current assets	2,556	2,102
Assets held for sale	-	600
Total current assets	24,611	27,145
Property and equipment:		
Land	31,639	31,629
Buildings and leasehold improvements	35,986	36,263
Machinery and equipment	11,802	11,456
Furniture and fixtures	576	527
Total property and equipment	80,003	79,875
Accumulated depreciation and amortization	(14,923)	(13,003)
Total property and equipment, net	65,080	66,872
Goodwill	2,820	3,587
Other intangible assets, net of accumulated amortization of $490 and $309 in 2005 and 2004, respectively	3,328	2,935
Deferred income taxes	-	2,008
Other assets	272	210
Total assets	$ 96,111	$ 102,757

See accompanying notes.

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LIABILITIES AND STOCKHOLDERS' EQUITY	**December 31, 2005**	**December 31, 2004**
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$ 2,209	$ 2,634
Accounts payable	4,231	4,077
Income taxes payable	320	278
Deferred revenue	501	469
Accrued expenses and other current liabilities	2,735	2,216
Total current liabilities	9,996	9,674
Long-term debt, net of current portion	24,435	26,480
Capital lease obligations, net of current portion	30	81
Commitments		
Stockholders' equity:		
Preferred stock, $.01 par value:		
Authorized shares - 10,000,000		
Issued and outstanding shares - none	-	-
Common stock, $.01 par value:		
Authorized shares - 100,000,000		
Issued and outstanding shares of 15,272,882 and 15,271,132 in 2005 and 2004, respectively	153	153
Additional paid-in capital	88,458	88,507
Accumulated other comprehensive income (loss)	167	(30)
Accumulated deficit	(27,128)	(22,108)
Total stockholders' equity	61,650	66,522
Total liabilities and stockholders' equity	$ 96,111	$ 102,757

See accompanying notes.

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Mace Security International, Inc. and Subsidiaries
Consolidated Statements of Operations

(In thousands, except share and per share information)

	Year ended December 31, 2005	2004	2003
Revenues:			
Car wash and detailing services	$ 35,081	$ 33,381	$ 35,655
Lube and other automotive services	3,437	3,504	4,147
Fuel and merchandise sales	4,815	4,130	3,613
Security sales	24,909	16,632	5,581
	68,242	57,647	48,996
Cost of revenues:			
Car wash and detailing services	25,274	23,754	25,983
Lube and other automotive services	2,627	2,729	3,188
Fuel and merchandise sales	4,220	3,577	3,156
Security sales	17,658	11,989	3,485
	49,779	42,049	35,812
Selling, general and administrative expenses	15,054	12,642	9,486
Depreciation and amortization	2,353	2,509	1,958
Costs of terminated acquisitions	-	53	-
Goodwill and asset impairment charges	2,529	8,225	3,798
Operating loss	(1,473)	(7,831)	(2,058)
Interest expense, net	(1,794)	(1,890)	(1,963)
Other income	686	267	438
Loss before income taxes	(2,581)	(9,454)	(3,583)
Income tax expense (benefit)	2,439	(3,044)	(50)
Net loss	$ (5,020)	$ (6,410)	$ (3,533)
Basic loss per share	$ (0.33)	$ (0.47)	$ (0.28)
Weighted average number of shares outstanding	15,271,637	13,679,604	12,414,816
Diluted loss per share	$ (0.33)	$ (0.47)	$ (0.28)
Weighted average number of shares outstanding	15,271,637	13,679,604	12,414,816

See accompanying notes.

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Mace Security International, Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity

(In thousands, except share information)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount				
Balance at December 31, 2002	12,407,655	$ 124	$ 69,710	-	$ (12,165)	$ 57,669
Common stock issued in purchase acquisitions	26,316		50			50
Exercise of common stock options	30,000	1	39			40
Shares purchased and retired	(12,200)		(14)			(14)
Net loss					(3,533)	(3,533)
Balance at December 31, 2003	12,451,771	125	69,785	-	(15,698)	54,212
Common stock issued in purchase acquisition	55,905	-	193			193
Exercise of common stock options	448,456	4	1,872			1,876
Common stock issued for land and building	250,000	3	1,561			1,564
Sales of common stock, net of issuance costs of $372	2,065,000	21	9,371			9,392
Proceeds from removal of restriction on shares, net of income tax of $3,227	-	-	5,725			5,725
Net loss					(6,410)	(6,410)
Change in fair value of cash flow hedge				(30)		(30)
Total Comprehensive loss						(6,440)
Balance at December 31, 2004	15,271,132	153	88,507	(30)	(22,108)	66,522
Net costs from issuance of common stock			(53)			(53)
Exercise of common stock options	1,750	-	4			4
Change in fair value of cash flow hedge				41		41
Unrealized gain on short-term investments				156		156
Net loss					(5,020)	(5,020)
Total comprehensive loss						(4,823)
Balance at December 31, 2005	15,272,882	$ 153	$ 88,458	$ 167	$ (27,128)	$ 61,650

See accompanying notes.

Mace Security International, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

(In thousands)

	Year ended December 31, 2005	2004	2003
Operating activities			
Net loss	$ (5,020)	$ (6,410)	$ (3,533)
Adjustments to reconcile net loss to net cash provided by operating activities, net of effects of acquisition:			
Depreciation and amortization	2,353	2,509	1,958
Provision for losses on receivables	232	225	86
Gain on short-term investments	(264)	-	-
Asset impairment charge-hurricane damage	107	-	-
Goodwill and asset impairment charges	2,529	8,225	3,798
(Gain) loss on disposal of property and equipment	(333)	18	(104)
Deferred income taxes	2,313	(3,470)	(155)
Changes in operating assets and liabilities:			
Accounts receivable	(450)	120	(845)
Inventory	(239)	(1,428)	(1,105)
Accounts payable	155	1,419	60
Deferred revenue	32	67	22
Accrued expenses	262	157	(197)
Income taxes	42	122	(39)
Prepaid expenses and other assets	(438)	(310)	191
Net cash provided by operating activities	1,281	1,244	137
Investing activities			
Acquisition of businesses, net of cash acquired	(1,900)	(5,621)	-
Purchase of property and equipment	(1,419)	(2,876)	(1,112)
Proceeds from sale of property and equipment	1,086	795	598
Purchase of short-term investments	(2,600)	-	-
Payments for intangibles	(12)	(86)	(55)
Net cash used in investing activities	(4,845)	(7,788)	(569)
Financing activities			
Proceeds from long term debt	-	-	11
Payments on long-term debt and capital lease obligations	(2,526)	(2,591)	(2,380)
(Costs) proceeds from issuance of common stock	(49)	11,268	40
Gross proceeds from removal of restriction on shares	-	8,952	-
Payments to purchase stock	-	-	(14)
Net cash (used in) provided by financing activities	(2,575)	17,629	(2,343)
Net (decrease) increase in cash and cash equivalents	(6,139)	11,085	(2,775)
Cash and cash equivalents at beginning of year	14,499	3,414	6,189
Cash and cash equivalents at end of year	$ 8,360	$ 14,499	$ 3,414

See accompanying notes.

Mace Security International, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

1. Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Mace Security International, Inc. and its wholly owned subsidiaries (collectively, "the Company" or "Mace"). All significant intercompany transactions have been eliminated in consolidation.

2. Summary of Significant Accounting Policies

Description of Business

The Company currently operates in two business segments: the Car and Truck Wash Segment, supplying complete car care and truck wash services (including wash, detailing, lube, and minor repairs) and the Security Segment, producing for sale consumer safety and personal defense products, as well as electronic surveillance and monitoring products. Beginning January 1, 2006, the truck washes are leased to a third party pursuant to a December 31, 2005 agreement with Eagle United Truck Wash, LLC. The Company's car care and truck wash operations are principally located in Texas, Arizona, Florida, Pennsylvania, New Jersey, Delaware, Indiana, and Ohio.

Revenue Recognition and Deferred Revenue

Revenue from the Company's Car and Truck Wash Segment is recognized, net of customer coupon discounts, when services are rendered or fuel or merchandise is sold. The Company records a liability for gift certificates, ticket books, and seasonal and annual passes sold at its car care locations but not yet redeemed. The Company estimates these unredeemed amounts based on gift certificates and ticket book sales and redemptions throughout the year as well as utilizing historical sales and redemption rates per the car washes' point-of-sale systems. Seasonal and annual passes are amortized on a straight-line basis over the time during which the passes are valid.

Revenue from the Company's Security Segment is recognized when shipments are made, or for export sales when title has passed. Shipping and handling charges and costs of $528,000, $322,000, and $98,000 in 2005, 2004, and 2003, respectively, are included in revenues and selling, general, and administrative expenses.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and highly liquid short-term investments with original maturities of three months or less, and credit card deposits which are converted into cash within two to three business days.

Short-Term Investments

At December 31, 2005, the Company had approximately $3.0 million of investments classified as available for sale in three funds which are stated at market value. The Company may exit one of the funds at the end of any calendar quarter with 30 days advanced written notice and the other funds may be exited with one business day notice. In the year ended December 31, 2005, the Company realized a total gain of $264,000. Additionally, an unrealized gain, net of tax, of approximately $156,000 is included as a separate component of equity in Accumulated Other Comprehensive Income (Loss) at December 31, 2005.

Accounts Receivable

The Company's accounts receivable are due from trade customers. Credit is extended based on evaluation of customers' financial condition and, generally, collateral is not required. Accounts receivable payment terms vary and amounts due from customers are stated in the financial statements net of an allowance for doubtful accounts. Accounts outstanding longer than the payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they are deemed uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. Risk of losses from international sales within the Security Segment are reduced by requiring substantially all international customers to provide irrevocable confirmed letters of credit and/or cash advances.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in first-out (FIFO) method for security and car care products. Inventories at the Company's car and truck wash locations consist of various chemicals and cleaning supplies used in operations and merchandise and fuel for resale to consumers. Inventories within the Company's Security Segment consist of defense sprays, child safety products, electronic security monitors, cameras and digital recorders, and various other consumer security and safety products.

Assets Held for Sale

The Company owned two warehouse bays in Hollywood, FL which were previously utilized in the Security Segment. At December 31, 2004, the bays were classified at their fair market values, net of estimated disposal cost, in our balance sheet as assets held for sale. Both bays were sold in 2005. Selling prices for the two bays were $420,000 and $306,000 and gains on the sales were $33,000 and $59,000, respectively.

Property and Equipment

Property and equipment are stated at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets, which are generally as follows: buildings and leasehold improvements - 15 to 40 years; machinery and equipment - 2 to 20 years; and furniture and fixtures - 5 to 10 years. Significant additions or improvements extending assets' useful lives are capitalized; normal maintenance and repair costs are expensed as incurred. Depreciation expense was approximately $2.2 million, $2.5 million and $1.9 million for the years ended December 31, 2005, 2004, and 2003, respectively. Maintenance and repairs are charged to expense as incurred and amounted to approximately $1.1 million, in 2005, $950,000 in 2004 and $900,000 in 2003.

Asset Impairment Charges

In accordance with Statement of Financial Accounting Standards ("SFAS") 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we periodically review the carrying value of our long-lived assets held and used, and assets to be disposed of, for possible impairment when events and circumstances warrant such a review.

Goodwill

In accordance with SFAS 142, we also completed our annual impairment tests as of November 30, 2005, 2004 and 2003 and will be subject to an impairment test each year thereafter. In the fourth quarter of 2005, as a result of the annual impairment test of Goodwill and Other Intangibles in accordance with SFAS 142, we recorded an impairment of approximately $1.56 million related to our Texas region reporting unit of our Car and Truck Wash Segment. This impairment charge was due to reductions in our future projected cash flows as volumes in this region continue to deviate from historic revenue levels. In the fourth quarter of 2004, we recorded an impairment of approximately $1.0 million related to our Northeast region reporting unit of our Car and Truck Wash Segment. Additionally, we recorded an impairment of approximately $6.7 million related to our Texas Region reporting unit of our Car and Truck Wash Segment. These were principally due to a reduction in future projected cash flows resulting from an extended departure from our historic revenue levels due to inclement weather, the lingering effects of a slower economy, and increased competition near several of our facilities in Texas and New Jersey. In the fourth quarter of 2003, as a result of the annual impairment test of Goodwill and Other Intangibles, we recorded an impairment of approximately $3.4 million related to our Northeast region reporting unit of our Car and Truck Wash Segment. Significant estimates and assumptions are used in assessing the fair value of the reporting units and determining impairment to goodwill (See Note 4, *Goodwill*). The Company cannot guarantee that there will not be impairments in subsequent years.

Other Intangible Assets

Other intangible assets consist primarily of deferred financing costs, trademarks, customer lists, product lists, and establishing a registered national brand name. In accordance with SFAS 142, our trademarks and brand name are considered to have indefinite lives and as such, are not subject to amortization. These assets will be tested for impairment annually and whenever there is an impairment indicator. In 2003, approximately $9,000 related to our security product trademarks was written off in accordance with SFAS 142. Customer lists and non-compete agreements are amortized on a straight-line basis over their respective estimated useful lives. Amortization of other intangible assets was approximately $185,000, $120,000 and $53,000 for the years ended December 31, 2005, 2004, and 2003, respectively. Deferred financing costs are amortized on a straight-line basis over the terms of the respective debt instruments.

Insurance

Commencing July 2002, the Company insures for auto, general liability, and workers' compensation claims through participation in a captive insurance program with other unrelated businesses. The Company maintains excess coverage through occurrence-based policies. With respect to participating in the captive insurance program, the Company set aside an actuarially determined amount of cash in a restricted "loss fund" account for the payment of claims under the policies. The Company fund these accounts annually as required by the captive insurance company. Should funds deposited exceed claims incurred and paid, unused deposited funds are returned to the Company with interest on or about the third anniversary of the policy year-end. The captive insurance program is further secured by a letter of credit in the amount of $973,000 at December 31, 2005. The Company records a monthly expense for losses up to the reinsurance limit per claim based on the Company's tracking of claims and the insurance company's reporting of amounts paid on claims plus their estimate of reserves for possible future payments and claims.

Income Taxes

Deferred income taxes are determined based on the difference between the financial accounting and tax bases of assets and liabilities. Deferred income tax expense (benefit) represents the change during the period in the deferred income tax assets and deferred income tax liabilities. Deferred tax assets include tax loss and credit carryforwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Supplementary Cash Flow Information

Interest paid on all indebtedness was approximately $2.1 million, $2.0 million and $2.0 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Income taxes paid were approximately $86,000, $340,000 and $144,000 in 2005, 2004, and 2003, respectively.

Noncash investing and financing activities of the Company include a property addition financed by common stock of $1.6 million, real estate partially funded by a mortgage of approximately $825,000, and the sale of property and simultaneous pay down of a related mortgage of $325,000, all in 2004 and property additions financed by debt of $343,000 in 2003.

Advertising

The Company expenses advertising costs, including advertising production costs, as they are incurred or the first time advertising takes place. The Company's costs of coupon advertising are recorded as a prepaid asset and amortized to advertising expense during the period of distribution and customer response, typically two to three months. Prepaid advertising costs were $67,000 and $25,000 at December 31, 2005 and 2004, respectively. Advertising expense was approximately $1.5 million in 2005, $1.2 million in 2004, $1.1 million in 2003.

Stock Based Compensation

The Company has two stock-based employee compensation plans, which are more fully described in Note 12. The Company accounts for those plans under the recognition and measurement principles of Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plan had exercise prices equal to the market value of the underlying common stock on the date of grant. The table below illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation,* to stock-based employee compensation.

As permitted by SFAS 123, the Company has elected to follow APB 25, and related Interpretations in accounting for its employee stock options. Under APB 25, if the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. In December 2004, the FASB issued SFAS 123(R) *Share-Based Payment.* SFAS 123 (R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. This statement is effective as of the first interim or annual reporting period of the first fiscal year beginning on or after June 15, 2005, which is January 1, 2006.

Pro forma information regarding net income and earnings per share is required by SFAS 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair values for these options were estimated at the dates of grant using a Black-Scholes option pricing model with the following weighted average assumptions for grants in 2005, 2004 and 2003; risk-free interest rate ranges of 4.06% to 4.57% in 2005, 3.80% to 4.56% in 2004 and 3.29% to 4.45% in 2003, dividend yield of 0%; expected volatility of the market price of the Company's common stock ranging from 52% to 56% in 2005, 20% to 64% in 2004 and 21% in 2003; and a weighted-average expected life of the option of ten years. The weighted-averages of the fair value of stock option grants were $1.88, $2.85 and $0.63 per share in 2005, 2004 and 2003, respectively.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. Pro forma results are not likely to be representative of the effects on reported or pro forma results of operations for future years. The Company's pro forma information is as follows (in thousands, except per share data):

	Year Ended December 31,					
		2005		**2004**		**2003**
Net loss, as reported	$	(5,020)	$	(6,410)	$	(3,533)
Less: Stock-based compensation costs under fair value based method for all awards		(648)		(2,089)		(401)
Pro forma net loss	$	(5,668)	$	(8,499)	$	(3,934)
Loss per share - basic						
As reported	$	(0.33)	$	(0.47)	$	(0.28)
Pro forma	$	(0.37)	$	(0.62)	$	(0.32)
Loss per share - diluted						
As reported	$	(0.33)	$	(0.47)	$	(0.28)
Pro forma	$	(0.37)	$	(0.62)	$	(0.32)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The Company's financial instruments consist primarily of cash and cash equivalents, trade receivables, trade payables and debt instruments. The carrying values of cash and cash equivalents, trade receivables, and trade payables are considered to be representative of their respective fair values.

Based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities, the carrying values and fair values of the Company's fixed and variable rate debt instruments at December 31, 2005 were as follows:

		Carrying Value		**Fair Value**
		(In thousands)		
Fixed rate debt	$	11,396	$	11,828
Variable rate debt		15,278		15,489
Total	$	26,674	$	27,317

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The majority of the fixed rate debt provides for a pre-payment penalty based on an interest rate yield maintenance formula. The yield maintenance formula results in a significant pre-payment penalty as market interest rates decrease. The pre-payment penalty precludes refinancing of this long-term debt.

Derivative Instruments

Statement of Financial Accounting Standard ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), as amended by SFAS No. 137 and SFAS No. 138, specifies the accounting and disclosure requirements for such instruments.

On October 14, 2004, we entered into an interest rate cap arrangement that effectively changes our interest rate exposure on approximately $7 million of variable rate debt. The variable rate debt floats at prime plus .25% (7.50% at December 31, 2005). The hedge contract has a 36-month term and caps the interest rate on the $7 million of variable rate debt at 6.5%. The derivative is designated as a cash flow hedge and, accordingly, is marked to market with gains and losses on the contract reported as a component of other comprehensive income (loss) and is classified into earnings in the earlier of (i) the period the hedged transaction affects earnings, or (ii) the termination of the hedge contract. At December 31, 2005 the contract which was originally purchased for $124,000, is included in other assets at its fair market value of approximately $130,000.

The interest rate cap arrangement was effective in hedging changes in cash flows related to certain debt obligations during 2005.

Business Combinations

In accordance with SFAS 141, *Business Combinations,* the Company allocates the cost of the acquired business to the assets acquired and the liabilities assumed based on estimates of fair values thereof. These estimates are revised during the allocation period as necessary when, and if, information regarding contingencies becomes available to define and quantify assets acquired and liabilities assumed. The allocation period varies but does not exceed one year. To the extent contingencies such as pre-acquisition environmental matters, pre-acquisition liabilities including deferred revenues, litigation and related legal fees are resolved or settled during the allocation period, such items are included in the revised allocation of the purchase price. After the allocation period, the effect of changes in such contingencies is included in results of operations in the period in which the adjustment is determined.

New Accounting Standard

In November 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards("SFAS") 151, *Inventory Costs - An Amendment of ARB No. 43, Chapter 4*. SFAS 151 amends the guidance in ARB 43Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS 151 is effective for fiscal years beginning after June 15, 2005 and is required to be adopted by the Company in the first quarter of fiscal 2006. The Company does not expect SFAS 151 to have a material impact on the Company.

In December 2004, the FASB issued SFAS 153, *Exchange of Nonmonetary Assets - An Amendment of APB Opinion No. 18 Accounting for Nonmonetary Transactions*. SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of Accounting Principles Board ("APB") Opinion 29, and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on the Company.

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment.* SFAS 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The cost will be measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) is effective as of the first interim or annual reporting period of the first fiscal year beginning on or after June 15, 2005. SFAS 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. In addition to the accounting standard that sets forth the financial reporting objectives and related accounting principles, SFAS 123 (R) includes an appendix of implementation guidance that provides expanded guidance on measuring the fair value of share-based payment awards. SFAS 123(R) replaces SFAS 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees*. SFAS 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in APB Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Additionally, in March 2005, the SEC issued Staff Accounting Bulletin ("SAB") 107, *Share-Based Payments*, which provides further guidance for the adopation of SFAS 123(R),discussed above. The Company will implement this new standard in the first quarter of our fiscal year 2006.

The Company expects the adoption of SFAS 123(R) to result in stock compensation expense and therefore a reduction of income before income taxes in 2006 between $650,000 and $700,000. The Company's actual stock compensation expense in 2006 could differ materially from this estimate depending on the timing and magnitude of new awards, the number of new awards and changes in the market price or the volatility of the Company's common stock.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections* ("SFAS 154") which replaces APB Opinion 20, *Accounting Changes* and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements - An Amendment of APB Opinion 28.* SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting priciple and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and, accordingly, is required to be adopted by the Company on January 1, 2006. The Company does not expect that the adoption of SFAS 154 will have a material impact on its consolidated results of operations and financial position.

3. Business Combinations

From April 1, 1999 through July 26, 2000, the Company acquired 62 car care facilities and five truck wash facilities through the acquisition of 17 separate businesses including: 42 full service facilities, one self service facility, 11 exterior only facilities and one lube center in Pennsylvania, New Jersey, Delaware, Texas, Florida, and Arizona; 13 facilities were subsequently divested or closed. The five full service truck wash facilities are located in Arizona, Indiana, Ohio, and Texas.

On August 12, 2002, the Company acquired the inventory, certain other assets and the operations of Micro-Tech Manufacturing, Inc. ("Micro-Tech"), a manufacturer and retailer of electronic security devices. Total consideration under the agreement was approximately $505,000. At closing, the Company paid $217,000 cash for inventory, $15,625 cash representing the first of twelve equal monthly installments totaling $187,500, and 13,158 (pre-reverse split) registered shares of common stock of the Company representing the first of eight quarterly payments of shares totaling 105,263 (pre-reverse split) shares. This transaction was accounted for using the purchase method of accounting in accordance with SFAS 141, *Business Combinations*.

On September 26, 2003, a wholly owned subsidiary within the Company's Security Segment acquired the inventory, certain other assets and the operations of Vernex, Inc., a manufacturer and retailer of electronic security monitors. Total consideration under the agreement was $213,000 cash for inventory and the issuance of 42,747 registered shares of the Company's common stock. This transaction was accounted for using the purchase method of accounting in accordance with SFAS 141, *Business Combinations*

On November 12, 2003, the Company sold, through a wholly owned subsidiary, the assets of our car wash facility located in Voorhees, New Jersey, for approximately $600,000.

On July 1, 2004, the Company, through its wholly owned subsidiary, Mace Security Products, Inc., acquired substantially all of the operating assets of Industrial Vision Source®("IVS") and SecurityandMore®("S&M") from American Building Control, Inc. The results of operations of IVS and S&M have been included in the consolidated financial statements of the Company since July 1, 2004. S&M supplies video surveillance and security equipment and IVS is a distributor of technologically advanced imaging components and video equipment. The acquisition of IVS and S&M furthers the Company's expansion of our Security Products Segment, and specifically the Electronic Surveillance Products Division. The acquisition also expands our presence in the southwestern part of the United States and provides us with new mass merchant opportunities, an active e-commerce web site, a catalog sales channel and a high-end digital and fiber optics camera product line. The purchase price for IVS and S&M consisted of approximately $5.62 million of cash and the assumption of $290,000 of current liabilities. The purchase was allocated as follows: approximately $1.86 million for inventory; $1.37 million for accounts receivable; $100,000 for equipment; and the remainder of $2.58 million allocated to goodwill and other intangible assets. Of the $2.58 million of acquired intangible assets, $830,000 was assigned to registered trademarks and $531,000 was assigned to goodwill, neither of which is subject to amortization expense. The remaining intangible assets were assigned to customer lists for $630,000 and product lists for $590,000. Customer and product lists were assigned a useful life of 10 years. The acquisition was accounted for as a business combination in accordance with SFAS 141*, Business Combinations.*

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The proforma financial information presented below gives effect to the IVS and S&M acquisition as if it had occurred as of the beginning of our fiscal year 2003. The information presented below is for illustrative purposes only and is not necessarily indicative of results that would have been achieved if the acquisition actually had occurred as of the beginning of 2003 or results which may be achieved in the future. Unaudited proforma financial information is as follows (in thousands, except per shares amounts):

	Twelve Months Ended December 31, 2004	Twelve Months Ended December 31, 2003
Revenues	$ 68,080	$ 70,469
Net loss	$ (6,269)	$ (2,853)
Loss per share-basic and dilutive	$ (0.46)	$ (0.23)

On August 3, 2004, the Company sold an exterior-only car wash facility in New Jersey. Proceeds from the sale of this facility, which was producing marginal cash flow, were approximately $645,000; slightly more than the site's net book value.

On November 23, 2005, the Company, through its wholly owned subsidiary, Mace Security Products, Inc., acquired the inventory and customer accounts of Securetek, Inc. ("Securetek") which specializes in the sale of electronic video surveillance system components to security alarm dealers and installers. The results of operations of Securetek have been included in the consolidated financial statements of the Company since November 23, 2005. The purchase price for Securetek consisted of $1.9 million cash. The purchase price was allocated $489,000 to inventory with the remainder to goodwill and other intangible assets. Of the $1.53 million of acquired intangible assets, $485,000 was assigned to customer lists, $85,000 to trademarks and a covenant-not-to-compete and the remainder of $957,000 to goodwill. Customer lists and the covenant-not-to compete were assigned useful lives of 10 years and 3.5 years, respectively. The acquired business was relocated and integrated into the Company's existing security operation in Ft. Lauderdale, Florida. The acquisition was accounted for as a business combination in accordance with SFAS 141, *Business Combinations.*

On December 20, 2005, the Company, through a wholly owned subsidiary, sold an exterior-only car wash facility in Pennsylvania. Proceeds from the sale of this facility were approximately $400,000 resulting in a $240,000 gain on disposal.

4. Goodwill

We completed our 2003 annual testing of goodwill and intangible assets determined to have indefinite lives in accordance with SFAS 142 as of November 30, 2003. The methodology applied was consistent with that of our transitional impairment testing and our 2002 annual test. The growth rate applied to future cash flows beyond detailed projections reward was 3%. The discount rates used varied from 7.25% to 15.0% for our security business and approximately 11% for our car and truck wash operations. In the fourth quarter of 2003, as a result of the annual impairment test of Goodwill and Other Intangibles, we recorded an impairment of approximately $3.4 million related to our Northeast region reporting unit of our Car and Truck Wash Segment. This was principally due to a reduction in future projected cash flows resulting from extended departures from our historic revenue levels due to inclement weather and a slower economy. Additionally, in the fourth quarter of 2004, as a result of the annual impairment test of Goodwill and Other Intangibles in accordance with SFAS 142, we recorded an impairment of approximately $1.0 million related to our Northeast region reporting unit of our Car and Truck Wash Segment. Additionally, we recorded an impairment of approximately $6.7 million related to our Texas region reporting unit of our Car and Truck Wash Segment. These impairments were principally due to reductions in future projected cash flows as determined during our 2005 budgeting process, which we completed in December, 2004. The projections of cash flows from these reporting units were reduced primarily due to two successive years of reductions in number of cars washed. We projected our car wash volume for 2004 based on the number of cars washed in these reporting units in the previous five years. We believe that fewer cars were actually washed during 2004 as a result of more inclement weather than in 2003, and increased competition near certain of our facilities in Texas and New Jersey. In the fourth quarter of 2005, we recorded an additional impairment of approximately $1.56 million related to our Texas region reporting unit of our Car and Truck Wash Segment. This impairment charge was due to reductions in our future projected cash flows as volumes in this region continue to deviate from historic revenue levels. The methodology applied in our 2005 annual impairment testing was consistent with that of our previous testing. We anticipate that the volume of cars washed in these regions will increase, if weather patterns return to the patterns existing in prior years. Impairment of goodwill and intangible assets with indefinite lives must be tested on at least an annual basis and whenever there is an impairment indicator. The Company cannot guarantee that there will not be impairments in subsequent years. The changes in the carrying amount of goodwill for the years ended December 31, 2004 and 2005 are as follows (in thousands):

	Northeast	Texas	Security Products	Total
Balance at December 31, 2002	$ 5,528	$ 7,620	$ 282	$ 13,430
Reallocation of purchase price	-	671	(40)	631
Impairment loss	(3,438)	-	-	(3,438)
Balance at December 31, 2003	$ 2,090	$ 8,291	$ 242	$ 10,623
Impairment Loss	(998)	(6,727)	-	(7,725)
Reallocation of purchase price	-	-	158	158
Acquisition of IVS and S&M	-	-	531	531
Balance at December 31, 2004	1,092	1,564	931	3,587
Impairment Loss	-	(1,564)	-	(1,564)
Reallocation of Purchase Price	-	-	(160)	(160)
Acquisition of Securetek	-	-	957	957
Balance at December 31, 2005	$ 1,092	$ -	$ 1,728	$ 2,820

5. Allowance for Doubtful Accounts

The changes in the allowance for doubtful accounts are summarized as follows:

	Year ended December 31,		
	2005	2004	2003
		(In thousands)	
Balance at beginning of year	$ 449	$ 263	$ 198
Additions (charged to expense)	232	225	86
Adjustments	-	125	-
Deductions	(88)	(164)	(21)
Balance at end of year	$ 593	$ 449	$ 263

6. Inventories

Inventories consist of the following:

	As of December 31,	
	2005	2004
	(In thousands)	
Finished goods	$ 6,094	$ 5,402
Work in process	67	112
Raw materials and supplies	508	527
Fuel, merchandise inventory and car wash supplies	1,232	1,026
	$ 7,901	$ 7,067

7. Other Intangible Assets

	December 31, 2005		December 31, 2004	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Non-compete agreement	$ 98	$ 21	$ 28	$ 13
Customer lists	1,184	165	699	79
Product lists	590	89	590	29
Deferred financing costs	416	215	421	188
Total amortized intangible assets	2,288	490	1,738	309
Non-amortized intangible assets:				
Trademarks - Security Segment	1,424	-	1,400	-
Service mark - Car and Truck Wash Segment	106	-	106	-
Total non-amortized intangible assets	1,530	-	1,506	-
Total intangible assets	$ 3,818	$ 490	$ 3,244	$ 309

The following sets forth the estimated amortization expense on intangible assets for the fiscal years ending December 31 (in thousands):

2006	$217
2007	$215
2008	$212
2009	$200
2010	$192

Amortization expense of other intangible assets was approximately $185,000, $120,000 and $53,000, for the years ended December 31, 2005, 2004, and 2003, respectively. The weighted average useful life of amortizing intangible assets was 10.2 years at December 31, 2005.

8. Long-Term Debt, Notes Payable, and Capital Lease Obligations

Long-term debt, notes payable, and capital lease obligations consist of the following:

	As of December 31, 2005	2004
	(In thousands)	
Notes payable to GMAC Commercial Mortgage ("GMAC"), interest rate of 8.52%, due in monthly installments totaling $145,936 including interest, through September 2013, collateralized by real property, equipment and inventory of certain of the Millennia Car Wash locations	$ 9,746	$ 10,625
Note payable to JPMorgan Chase Bank, N.A. ("Chase"), the successor of Bank One, Texas, N.A., interest rate of prime plus 0.25%(7.50% at December 31, 2005), is due in monthly installments of $59,235 including interest (adjusted annually), through November 2008, collateralized by real property and equipment of Eager Beaver Car Wash, Inc.	4,995	5,306
Notes payable to Chase, interest rate of prime plus 0.25% (7.50% at December 31, 2005) due in monthly installments totaling 44,797 per month including interest (adjusted annually) through various dates ranging from January 2005 to October 2009, collateralized by real property and equipment of certain of the Colonial Car Wash locations	3,132	3,480
Note payable to Chase, which refinanced a note payable to Cornett Ltd. Partnership on February 17, 2000. The Chase note, which provides for an interest rate of prime plus 0.25% (7.50% at December 31, 2005), is due in monthly installments of $41,255 including interest (adjusted annually), renewed through February 2008, collateralized by real property and equipment of the Genie Car Wash locations	3,532	3,785
Note payable to Western National Bank, interest rate of 8.75%, due in monthly installments of $20,988 including interest, through October 2014, collateralized by real property and equipment in Lubbock, Texas	1,565	1,671
Note payable to Business Loan Express, interest rate of prime plus 2.5% (9.75% at December 31, 2005), is due in monthly installments of $13,003 including interest (adjusted annually), through December 2022, collateralized by real property and equipment of the Blue Planet Car Wash	1,338	1,372
Note payable to Merriman Park J.V., interest rate of 7.0% (adjusted annually), due in monthly installments of $10,147 including interest, through November 2011, collateralized by real property and equipment of certain of the Colonial Car Wash locations	588	671
Note payable to Chase, interest rate of prime plus 0.25% (7.50% at December 31, 2005), is due in monthly installments of $7,315 including interest (adjusted annually), through July 2006, collateralized by real property and equipment of the Superstar Kyrene Car Wash	623	665
Note payable to Chase, interest rate of prime plus 0.25% (7.50% at December 31, 2005), is due in monthly installments of $2,705 including interest (adjusted annually) through April 2010, collateralized by real property and equipment of the Red Baron Amarillo Truck Wash	283	295
Note payable to Wachovia, interest rate of one month LIBOR plus 2.50% (4.91% at December 31, 2004), was due in monthly principal payments of $4,049 plus accrued interest, and was collateralized by real property of Mace Security Products, Inc.	-	337
Capital lease payable to Columbia Credit Company, interestrate of 14.5%, due in monthly installments of $8,314 including interest, through May 2005, and was collateralized by certain equipment of the Shammy Man Car Wash location	-	32

Capital leases payable to various creditors, interest rates ranging from 7.75% to 9.97%, due in monthly installments of $5,930 including interest, through July 2007, collateralized by certain equipment of the Company		85		141
Note payable to Chase, interest rate of prime plus 0.25% (7.50% at December 31, 2005) due in monthly Installments of $7,363 including interest (adjusted annually), through September 2009, collateralized by real property and equipment of Mace Security Products, Inc.		787		815
		26,674		29,195
Less: current portion		2,209		2,634
	$	24,465	$	26,561

Of the 48 car washes owned or leased by us at December 31, 2005, 25 properties and related equipment with a net book value totaling $40.4 million secured first mortgage loans totaling $25.5 million.

The Company has available a short-term line of credit with Chase, Texas, N.A. which provides borrowing for inventory and accounts receivable financing up to $500,000 for the Company's electronic surveillance operations. The availability under this line of credit is subject to an inventory and accounts receivable borrowing formula. There were no borrowings outstanding under this line of credit at December 31, 2005.

At December 31, 2005, the Company had three letters of credit outstanding totaling $1,078,000 as collateral relating to workers' compensation insurance policies.

Several of our debt agreements, as amended, contain certain affirmative and negative covenants including certain financial reporting requirements, the maintenance of certain levels of tangible net worth, maintenance of certain unencumbered cash and marketable securities balances, limitations on capital spending, and the maintenance of certain debt coverage ratios on a consolidated level. At December 31, 2005 we were not in compliance with our consolidated debt coverage ratios related to our GMAC notes payable and the limitation on capital spending related to our Chase notes payable. With respect to the GMAC notes payable, the Company's debt service coverage requirement is 1.25:1. At December 31, 2005, the Company's debt service coverage ratio was 1.07:1 and accordingly was not in compliance with the GMAC covenant. Additionally, the Mace guaranty agreement with GMAC requires the Company to provide GMAC audited, reviewed, or compiled financial statements by the Company's independent certified public accountants within 90 days of the Company's fiscal year end. The Company was not able to timely provide the required year end audited financial statements. GMAC granted us a waiver of acceleration related to the non-compliance with the debt coverage ratio covenant and delinquency in providing the Company's year end audited financial statements at December 31, 2005, and for measurement periods through April 1, 2007 and, accordingly, a portion of the GMAC notes payable was reflected as non-current on our consolidated financial statements at December 31, 2005. Additionally, the Company has entered into amendments to the Chase term loan agreements effective March 31, 2004. The amended debt coverage ratio with Chase requires the Company to maintain a consolidated earnings before interest, income taxes, depreciation and amortization ("EBITDA") to debt service (collectively " the debt service coverage ratio") of 1.05:1 at December 31, 2004 and thereafter. The Company's debt service coverage ratio was 1.09:1 at December 31, 2005 and accordingly was in compliance with this Chase covenant, as amended. The amended Chase term loan agreement also limits capital expenditures annually to $1.0 million and requires the Company to provide Chase with a Form 10-K and audited financial statements within 120 days of the Company's fiscal year end as well as internal certified financial statements and a Form 10-Q within 60 days after the end of each fiscal quarter. The Company was not able to timely provide the required year end audited financial statements or the first quarter Form 10-Q. The Company incurred capital expenditures of $1.4 million in 2005 and, accordingly, was not in compliance with this Chase covenant. The Company received a waiver of acceleration from Chase at December 31, 2005 and for measurement periods through January 1, 2007 related to exceeding the annual capital expenditure limit and the untimely financial statement filings and, accordingly, a portion of the Chase notes payable was reflected as non-current on our consolidated financial statements at December 31, 2005. The Chase amendment also requires the maintenance of a minimum total unencumbered cash and marketable securities balance of $5 million. This cash balance requirement will be lowered to $1 million upon the Company returning to a debt coverage ratio of at least 1.10:1.

The Company sold or closed six unprofitable or marginally profitable car wash facilities and a lube facility from 2003 through 2005 and increased its prices in March 2004 within the Car and Truck Wash Segment to help improve cash flows for fiscal 2004. If our future cash flows are less than expected or debt service including interest expense increases more than expected causing us to further default on any of the Chase covenants or the GMAC covenant in the future, the Company will need to obtain further amendments or waivers from these lenders. If the Company is unable to obtain waivers or amendments in the future, Chase debt currently totaling $13.4 million and GMAC debt currently totaling $9.7 million, including debt recorded as long-term debt at December 31, 2005, would become payable on demand by the financial institution upon expiration of the current waivers. The Company's ongoing ability to comply with its debt covenants under its credit arrangements and refinance its debt depends largely on the achievement of adequate levels of cash flow. Our cash flow has been and could continue to be adversely affected by weather patterns, economic conditions, and the requirements to fund our security business that we are attempting to grow. In the event that non-compliance with the debt covenants should reoccur, the Company would pursue various alternatives to attempt to successfully resolve the non-compliance, which might include, among other things, seeking additional debt covenant waivers or amendments, or refinancing debt with other financial institutions. There can be no assurance that further debt covenant waivers or amendments would be obtained or that the debt would be refinanced with other financial institutions at favorable terms. If we are unable to obtain renewals on maturing loans or refinancing of loans on favorable terms, our ability to operate would be materially and adversely affected.

Certain machinery and equipment notes payable discussed above have been classified as capital lease obligations in the balance sheet.

Maturities of long-term debt are as follows: 2006 - $2.2 million, 2007 - $2.4 million, 2008 - $7.1 million, 2009 - $7.0 million, 2010 - $1.6 million, 2011 and thereafter - $6.4 million.

9. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of the following:

	As of December 31,			
	2005		2004	
	(In thousands)		(In thousands)	
Accrued compensation	$	928	$	945
Property and other non-income taxes		462		317
Other		1,345		954
	$	2,735	$	2,216

10. Interest Expense, net

Interest expense, net of interest income consists of the following:

	Year Ended December 31					
	2005		2004		2003	
Interest expense	$	(2,086)	$	(2,010)	$	(2,006)
Interest income		292		120		43
	$	(1,794)	$	(1,890)	$	(1,963)

11. Other Income (Expense)

Other income(expense) consists of the following:

	Year Ended December 31					
	2005		2004		2003	
Investment income	$	266	$	-	$	-
Rental income		169		159		208
Gain (loss) on sale of fixed assets		333		(15)		107
Hurricane damage loss		(107)		-		-
Business interruption insurance proceeds		-		59		115
Reserve for note receivable		-		-		(100)
Other		25		64		108
	$	686	$	267	$	438

12. Stock Option Plans

During September 1993, the Company adopted the 1993 Stock Option Plan (“the 1993 Plan”). The 1993 Plan provides for the issuance of up to 630,000 shares of common stock upon exercise of the options. The Company has reserved 630,000 shares of common stock to satisfy the requirements of the 1993 Plan. The options are non-qualified stock options and are not transferable by the recipient. The 1993 Plan is administered by the Compensation Committee (“the Committee”) of the Board of Directors, which may grant options to employees, directors and consultants to the Company. The term of each option may not exceed fifteen years from the date of grant. Options are exercisable over either a 10 or 15 year period and exercise prices are not less than the market value of the shares on the date of grant.

In December 1999, the Company’s stockholders approved the 1999 Stock Option Plan (“the 1999 Plan”) providing for the granting of incentive stock options or nonqualified stock options to directors, officers, or employees of the Company. Under the 1999 Plan, 15,000,000 shares of common stock are reserved for issuance. Incentive stock options and nonqualified options have terms which are determined by the Committee with exercise prices not less than the market value of the shares on the date of grant. The options generally expire ten years from the date of grant and are exercisable based upon graduated vesting schedules as determined by the Committee. As of December 31, 2005, 4,177,944 options have been granted under the 1993 and 1999 Plans including 3,719,760 nonqualified stock options.

Activity with respect to these plans is as follows:

	2005			2004			2003		
	Number		Weighted Average Exercise Price	Number		Weighted Average Exercise Price	Number		Weighted Average Exercise Price
Options outstanding beginning of period	2,971,264	$	4.03	1,957,033	$	4.27	1,305,283	$	5.72
Options granted	300,000	$	2.73	1,539,932	$	4.05	791,000	$	1.42
Options exercised	(1,750)	$	1.85	(448,456)	$	4.19	(30,000)	$	1.32
Options canceled	(160,832)	$	2.30	(77,245)	$	9.04	(109,250)	$	1.81
Options outstanding end of period	3,108,682	$	4.00	2,971,264	$	4.03	1,957,033	$	4.27
Options exercisable	2,696,684			2,329,764			1,417,895	$	5.28
Shares available for granting of options	3,984,382			4,123,550			5,586,237		

Stock options outstanding at December 31, 2005 under both plans are summarized as follows:

Range of Exercise Prices	Number Outstanding	Weighted Avg. Remaining Contractual Life		Weighted Avg. Exercise Price
$1.28-$1.91	749,709	7.2	$	1.43
$1.94-$2.97	653,147	7.7	$	2.53
$3.00-$4.45	860,308	8.8	$	3.93
$5.00-$5.59	632,291	6.8	$	5.34
$8.63-$11.75	71,160	4.1	$	10.06
$13.25-$19.50	132,067	3.5	$	15.22
$22.00	10,000	3.4	$	22.00
	3,108,682			

In 1999, the Company issued warrants to purchase a total of 1,328,250 shares of the Company's common stock at a weighted average exercise price of $4.22 per share (shares and exercise price are adjusted for one-for-two reverse stock split) in connection with the purchase of certain businesses and to a director. The terms of the warrants have been established by the Board of Directors. The warrants are exercisable at various dates through August 2, 2009 and have exercise prices ranging from $2.75 to $18.50 per share. Through December 31, 2005, 281,818 warrants to purchase common stock have been exercised and 996,432 warrants to purchase common stock have expired. In 2004, the Company issued warrants to purchase a total of 383,000 shares of the Company's common stock at a weighted average price of $6.65 per share which expire in 2009. The Company has a total of 433,000 warrants to purchase common stock outstanding at December 31, 2005, all of which are exercisable.

During the exercise period, the Company will reserve a sufficient number of shares of its common stock to provide for the exercise of the rights represented by option and warrant holders.

13. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities at December 31, 2005 and 2004 are as follows:

	As of December 31,			
	2005		**2004**	
	(In thousands)		(In thousands)	
Deferred tax assets:				
Allowance for doubtful accounts	$	267	$	134
Inventories		28		28
Net operating loss carryforwards		6,543		6,202
Deferred revenue		197		184
Compensation		45		117
Car damage reserve		49		28
Accrued workers compensation costs		16		16
Federal Tax Credit		179		179
Other, net		72		-
Total deferred tax assets		7,396		6,888
Valuation allowance for deferred tax assets		(4,126)		(896)
Deferred tax assets after valuation allowance		3,270		5,992
Deferred tax liabilities:				
Property, equipment and intangibles		(3,270)		(3,663)
Net deferred tax assets	$	-	$	2,329

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At December 31, 2005, the Company had U.S. federal net operating loss carryforwards of approximately $18.015 million. The U.S. federal net operating loss carryforwards expire as follows:

Year of Expiration	Amount
2018	$ 989
2019	4,006
2020	3,239
2021	1,583
2022	2,822
2023	4,411
2025	965
	$ 18,015

Additionally, the Company has $1.3 million of acquired corporation's preacquisition state net operating loss carryforwards expiring from 2008 through 2018.

Realization of the future tax benefits related to the deferred tax assets is dependent upon many factors, including the Company's ability to generate taxable income in future years. The Company performed a detailed review of the considerations influencing our ability to realize the future benefit of the NOLs, including, the extent of recently used NOLs, the turnaround of future deductible temporary differences, the duration of the NOL carryforward period, and the Company's future projection of taxable income. The Company increased its valuation allowance against deferred tax assets by $3.2 million in 2005 with a total valuation allowance of $4.1 million at December 31, 2005 representing the amount of its deferred income tax assets in excess of the Company's deferred income tax liabilities. The valuation allowance was recorded because management was unable to conclude that realization of the net deferred income tax asset was more likely than not. This determination was a result of the Company's continued losses in its fiscal year ended December 31, 2005, the uncertainty of the timing of the Company's transition from the Car Wash business, and the ultimate extent of growth in the Company's Security Segment.

The components of income tax expense (benefit) are (in thousands):

	Year ended December 31,		
	2005	2004	2003
		(In Thousands)	
Current (principally state taxes)	$ 126	$ 112	$ 106
Deferred	2,313	(3,156)	(156)
Total income tax expense(benefit)	$ 2,439	$ (3,044)	$ (50)

The significant components of deferred income tax expense(benefit) attributed to the loss for the years ended December 31, 2005, 2004, and 2003 are as follows (In thousands):

	Year ended December 31,		
	2005	2004	2003
Deferred tax expense (benefit)	$ 133	$ (1,780)	$ 2,074
Loss carryforward	(1,110)	(1,400)	(2,002)
Valuation allowance for deferred tax assets	3,290	24	(228)
	$ 2,313	$ (3,156)	$ (156)

A reconciliation of income tax benefit computed at the U.S. federal statutory tax rates to total income tax expense (benefit) is as follows:

	Year ended December 31, (In thousands)		
	2005	2004	2003
Tax at U.S. federal statutory rate	$ (903)	$ (3,175)	$ (1,255)
State taxes, net of federal benefit	40	(124)	233
Goodwill impairment	-	349	1,203
Nondeductible costs and other acquisition accounting adjustments	12	16	7
Valuation allowance for deferred tax assets	3,290	24	(228)
Other adjustments	-	(134)	(10)
Total income tax expense (benefit)	$ 2,439	$ (3,044)	$ (50)

14. Loss Per Share

The following table sets forth the computation of basic and diluted loss per share: (in thousands except loss per share)

	Year ended December 31,		
	2005	2004	2003
Numerator (In thousands):			
Net loss	$ (5,020)	$ (6,410)	$ (3,533)
Denominator:			
Denominator for basic loss per share - weighted average shares	15,271,637	13,679,604	12,414,816
Dilutive effect of options and warrants	-	-	-
Denominator for diluted lossper share - weighted average shares	15,271,637	13,679,604	12,414,816
Basic loss per share:			
Net loss	$ (0.33)	$ (0.47)	$ (0.28)
Diluted loss per share:			
Net loss	$ (0.33)	$ (0.47)	$ (0.28)

The dilutive effect of options and warrants of 275,044, 491,082, and 40,399 at December 31, 2005, 2004 and 2003, respectively, have not been included in the calculation of diluted earnings per share because they are anti-dilutive.

15. Concentration of Credit Risk

The Company maintains its cash accounts in high quality financial institutions. At times, these balances may exceed insured amounts.

16. Commitments and Contingencies

The Company is obligated under various operating leases, primarily for certain equipment, vehicles, and real estate. Certain of these leases contain purchase options, renewal provisions, and contingent rentals for the proportionate share of taxes, utilities, insurance, and annual cost of living increases. Future minimum lease payments under operating leases with initial or remaining noncancellable lease terms in excess of one year as of December 31, 2005 are as follows: 2006 - $919,000 million; 2007 - $874,000; 2008 - $734,000; 2009 - $545,000; 2010 - $424,000 and thereafter - $2.3 million. Rental expense under these leases was $1.3 million, $1.3 million and $1.7 million for the years ended December 31, 2005, 2004, and 2003, respectively.

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The Company has produced documents requested in subpoena issued in connection with an investigation conducted by the United States Securities and Exchange Commission of possible securities law violations. The subpoena was issued on October 27, 2003. The Company produced all documents that were requested and has not been contacted by the United States Securities and Exchange Commission regarding the investigation since February, 2004. The Company intends to fully cooperate with the United States Securities and Exchange Commission's investigation.

On July 20, 2004, the Company received a letter from the United States Securities and Exchange Commission. This letter requested that the Company voluntarily provide information and documents relating to Price Legacy Corporation's sale of 1,875,000 shares of the Company's common stock on the open market in April, 2004 and Price Legacy Corporation's payment of $8.95 million to the Company in exchange for the Company removing a sales restriction from 1,750,000 of the shares that were sold. The Company supplied the information in August of 2004. The Company has not been contacted by the Securities and Exchange Commission since supplying the information. The Company intends to fully cooperate with the United States Securities and Exchange Commission in this matter.

The Company subleases a portion of the building space at several of its car wash facilities either on a month-to-month basis or under cancellable leases. During fiscal 2005, 2004, and 2003 revenues under these leases were approximately $179,000, $163,000 and $214,000, respectively. These amounts are classified as other income in the accompanying statements of operations.

The Company is subject to federal and state environmental regulations, including rules relating to air and water pollution and the storage and disposal of oil, other chemicals, and waste. The Company believes that it complies, in all material respect, with all applicable laws relating to its business.

Certain of the Company's executive officers have entered into employee stock option agreements whereby options issued to them shall be entitled to immediate vesting should the officer be terminated upon a change in control of the Company. Additionally, the employment agreement of the Company's Chief Executive Officer, Louis D. Paolino, Jr., entitles Mr. Paolino to receive a fee of $2.5 million upon termination of employment under certain conditions. The employment agreement also provides for a bonus of $2.5 million upon a change in control.

In December 2003, one of the Company's car wash subsidiaries was named as a defendant in a suit filed by Kristen Sellers in the Circuit Court of the Twelfth Judicial Circuit in and for Sarasota County, Florida. The suit alleged that the plaintiff was entitled to damages in excess of $15,000 due to psychological injury and emotional distress sustained when an employee of the car wash allegedly assaulted Ms. Sellers with sexually explicit acts and words. The case has been settled and the Company's insurer has paid the plaintiff $200,000 in compensation and approximately $55,000 in reimbursement of litigation costs.

The Company is a party to various legal proceedings related to its normal business activities. In the opinion of the Company's management, none of these proceedings are material in relation to the Company's results of operations, liquidity, cash flows, or financial condition.

17. Asset Impairment Charges

In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we periodically review the carrying value of our long-lived assets held and used, and assets to be disposed of, for possible impairment when events and circumstances warrant such a review. Assets classified as held for sale are measured at the lower of carrying value or fair value, net of costs to sell. During the year ended December 31, 2002, we wrote down assets determined to be impaired by approximately $1.2 million. The asset write-down related to one of our full service car wash sites in Texas and two full service car wash sites in Arizona. We have determined that due to changing demographics and increased competition in the geographic areas of these sites, their future expected cash flows will not be sufficient to recover their respective carrying values. During the quarter ended June 30, 2003, we further wrote down the assets related to one of the full service car wash sites in Arizona which we partially wrote down at December 31, 2002, by an additional $351,000. The additional write-down was the result of the impending loss of a significant customer of this site resulting in an additional reduction of the future expected cash flows of this site and the ability to recover the site's carrying value. We closed the facility effective September 30, 2003. During the quarter ended June 30, 2004, we sold the other Arizona car wash site recording a loss of $51,000 on the disposition. We continue to market the Texas site for sale and have written down these assets to their estimated fair market values. Additionally, as a result of our SFAS144 quarterly review during the year ended December 31, 2004, we wrote down assets related to our truck wash operations determined to be impaired by approximately $500,000 and an additional $966,000 during the quarter ended September 30, 2005 as a result of our SFAS 144 quarterly reviews. We have determined that due to a reduction in truck wash volumes resulting from an increase in inclement weather, increased competition, the significant increase in fuel costs which had the effect of reducing spending on truck washing, and demographic changes to certain of our facilities, their future expected cash flows would not be sufficient to recover their respective carrying values. The Company executed a lease-to-sell agreement on December 31, 2005 with Eagle United Truck Wash, LLC ("Eagle") to lease Mace's five truck washes beginning January 1, 2006 for up to two years. Pursuant to the terms of the agreement, Eagle must pay Mace $9,000 per month to lease the Company's truck washes, and is responsible for all underlying property expenses. Within the next two years, Eagle is obligated under the agreement to purchase the truck washes and be delivered title to the assets for $1.2 million, consideration consisting of $280,000 cash and a $920,000 note payable to Mace secured by mortgages on the truck washes. When issued, the $920,000 note will have a five-year term, with principal and interest paid on a 15-year amortization schedule. If Eagle does not fulfill its obligation to purchase the truck washes, the Company will regain possession of the truck washes and Eagle will be obligated to pay $200,000 as liquidated damages.

18. Related Party Transactions

From November, 2001 through July 2002, the Company prepaid LP Learjets, LLC $5,109 per month for the right to use a Learjet 31A for 100 hours per year. LP Learjets, LLC is a company owned by Louis D. Paolino, Jr., the Company's Chairman, Chief Executive Officer and President. When the Learjet 31A is used, the prepaid amount is reduced by the hourly usage charge as approved by the Audit Committee, and the Company pays to third parties unaffiliated with Louis D. Paolino, Jr., the direct costs of the Learjet's per-hour use, which include fuel, pilot fees, engine insurance and landing fees. The balance of unused prepaid flight fees totaled $31,659 at December 31, 2005.

Louis D. Paolino, Jr. purchased approximately $44,600 and $20,600 of the Company's products in fiscal 2005 and 2004, respectively, at a discount from the prices charged to distributors. The total of the discount given to Mr. Paolino was approximately $18,300 and $6,600 in fiscal 2005 and 2004, respectively.

The Company's Security Segment leases manufacturing and office space under a five-year lease with Vermont Mill, Inc. ("Vermont Mill"), which provided for monthly lease payments of $9,167 through November 2004. Vermont Mill is controlled by Jon E. Goodrich, a former director and current employee of the Company. The Company has exercised an option to continue the lease through November 2009 at a rate of $10,576 per month. The Company believes that the lease rate is lower than lease rates charged for similar properties in the Bennington, Vermont area. On July 22, 2002, the lease was amended to provide Mace the option and right to cancel the lease with proper notice and a payment equal to six months of the then current rent for the leased space occupied by Mace. Rent expense under this lease was $126,000, $111,000 and $110,000 for 2005, 2004, and 2003, respectively.

From January 1, 2004 through December 31, 2005, the Company's Security Segment sold approximately $146,300 of electronic security equipment to two companies, each of which Louis Paolino, III, the son of the Company's CEO, Louis D. Paolino, Jr., is a partial owner. The pricing extended to these companies is no more favorable than the pricing given to third party customers who purchase in similar volume. At December 31, 2005, $13,529 was owed from one of these companies to Mace.

On September 29, 2005, Louis Paolino III, the son of the Company's Chief Executive Officer, Louis Paolino, Jr., purchased from the Company a warehouse bay in Hollywood, Florida that is no longer used in the Company's operations for $306,000 in cash. The Company's Audit Committee authorized the Company on February 14, 2005 to proceed with a sale of the warehouse property to Louis Paolino III for $306,000. The Company paid $256,688 for the property in 2003. The warehouse property was appraised by a third party independent appraiser on January 18, 2005 at an estimated market value of $306,000.

19. Segment Reporting

The Company currently operates in two segments: the Car and Truck Wash Segment, supplying complete car care services (including wash, detailing, lube, and minor repairs), fuel, and merchandise sales; and the Security Segment.

The Company evaluates performances and allocates resources based on operating income of each reportable segment rather than at the operating unit level. The Company defines operating income as revenues less cost of revenues, selling, general and administrative expense, and depreciation and amortization expense. The accounting policies of the reportable segments are the same as those described in the *Summary of Significant Accounting Policies* (see Note 2). There is no intercompany profit or loss recognized on intersegment sales.

The Company's reportable segments are business units that offer different services and products. The reportable segments are each managed separately because they provide distinct services or produce and distribute distinct products through different processes.

Selected financial information for each reportable segment is as follows:

	Year ended December 31,		
	2005	**2004**	**2003**
Revenues:		(In thousands)	
Car and truck wash - external customers	$ 43,333	$ 41,015	$ 43,415
Security - external customers	24,909	16,632	5,581
	$ 68,242	$ 57,647	$ 48,996
Segment Operating (loss) income:			
Corporate (1)	$ (3,450)	$ (3,485)	$ (2,987)
Car and truck wash	4,534	4,300	4,917
Security	(28)	(368)	(190)
	$ 1,056	$ 447	$ 1,740
Assets:			
Car and truck wash	$ 75,876	$ 83,978	$ 83,262
Security	20,235	18,779	7,340
	$ 96,111	$ 102,757	$ 90,602
Capital expenditures:			
Corporate	$ 10	$ 5	$ 5
Car and truck wash	1,140	1,456	872
Security	424	3,809	578

	$	1,574	$	5,270	$	1,455
Depreciation and amortization:						
Corporate	$	43	$	62	$	62
Car and truck wash		1,911		2,187		1,795
Security		399		260		101
	$	2,353	$	2,509	$	1,958

(1) Corporate functions include the corporate treasury, legal, financial reporting, information technology, corporate tax, corporate insurance, human resources, investor relations, and other typical centralized administrative functions.

A reconciliation of operating income for reportable segments to total reported operating loss is as follows:

	Year ended December 31, 2005	2004	2003
	(In thousands)		
Total operating income for reportable segments	$ 1,056	$ 447	$ 1,740
Costs of terminated acquisitions	-	(53)	-
Goodwill and asset impairment charges	(2,529)	(8,225)	(3,798)
Total reported operating loss	$ (1,473)	$ (7,831)	$ (2,058)

20. Subsequent Events

(Unaudited) On March 13, 2006, the Company was served with a search warrant issued by the United States District Court for the District of New Jersey relating to a criminal immigration investigation. A search of the Company's headquarters and four out of the Company's 48 car washes was conducted by representatives of the United States Department of Investigations and Customs Enforcement and certain other agencies. Three of the car washes searched are located in Pennsylvania and the fourth is located in New Jersey. Documents were seized and a number of car wash employees of Car Care, Inc., a wholly-owned subsidiary of the Company, were taken into custody by the United States immigration authorities. The Company was also served with a federal grand jury subpoena seeking similar documents. The Company is in the process of responding to the subpoena. The Company has been informed by the government that it is a subject of the government's investigation. The Company's Audit Committee retained independent outside counsel ("Special Counsel") to conduct an independent investigation of the Company's hiring practices at the Company's car washes and other related matters. Special Counsel provided a written summary of findings on April 18, 2006 to the Company's Audit Committee. The investigative finding included, among other things, a finding that the Company's internal controls for financial reporting at the corporate level are adequate and appropriate, and that there is no financial statement impact implicated by the Company's hiring practices, except for a potential contingent liability. Beginning on April 21, 2006, Special Counsel began to receive for review some additional and previously requested but unavailable documents and information, including the documents the government seized on March 13, 2006. On May 18, 2006, Special Counsel issued its Review of Information Supplemental to Internal Investigation which states that the review of the additional documents and information has not changed the conclusions contained in the April 18, 2006 summary of findings. See Item 3, Legal Proceedings. From March 13, 2006 through May 31, 2006, the Company incurred $390,000 in legal, consulting and accounting expenses associated with the Audit Committee investigations and $375,000 associated with the governmental investigation and Company's defense and negotiations with the government. In accordance with the Company's By-Laws, the Company is obligated to indemnity and advance legal costs for its officers and directors. The Company has hired a Human Resources Manager and has incorporated additional internal control procedures at the corporate, regional and site level to further enhance the existing internal controls with respect to the Company's hiring procedures at the car wash locations to prevent the hiring of undocumented workers. There is a possibility that the United States Attorney for the Eastern District of Pennsylvania may prosecute the Company at the conclusion of its investigation. Violations of law may result in civil, administrative or criminal fines or penalties. Due to the ongoing nature of the criminal investigation, it is not possible at this time to predict the outcome of the investigation or the impact of costs of ultimately resolving this matter on our results of operations or financial condition. However, any fees, expenses, fines or penalties which might be incurred by the Company in connection with the hiring of undocumented workers may have a material impact on the Company's results of operations and financial condition. The Company has made no provision for any future costs associated with the investigations or any future costs associated with the Company's defense or negotiations with governmental authorities to resolve these outstanding issues.

On February 28, 2006, the Company signed an agreement to sell its Arizona car wash region to CW Acquisition, LLC for $19.5 million. The purchase price consists of $18.5 million in cash and $1.0 million to be paid to the Company in the form of a three-year promissory note bearing 7.5% interest. The note , when issued, would have a $250,000 principal payment due on each of the first and second anniversary dates of the promissory note's issuance, with the balance of $500,000 due and payable on the third anniversary. The transaction is expected to close by July 31, 2006.

On June 16, 2006, the Company sold its Deptford, New Jersey exterior only car wash for $1.025 million in cash.

On April 19, 2006 and May 17, 2006, the Company received two separate Nasdaq Staff Determinations that it was not in compliance with Marketplace Rule 4310(c) (14) regarding the requirement to file with The Nasdaq Stock Market all documents required to be filed with the Securities and Exchange Commission. The April 19, 2006, Nasdaq Staff Determination was issued due to the Company not timely filing its Annual Report on Form 10-K for the year ended December 31, 2005 ("Form 10-K"). The May 17, 2006 Nasdaq Staff Determination was issued due to the Company not timely filing its Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 ("Form 10-Q"). In accordance with the procedures for the Nasdaq Stock Market, the Company requested that the Nasdaq Hearing Qualifications Panel ("Panel") grant the Company an exception to Marketplace Rule 4310(c) (14) that would allow the Company's stock to remain listed. A hearing before the Panel was held on May 25, 2006. The Panel issued its ruling on June 28, 2006. The Panel's ruling granted an exception allowing the Company's common stock to remain listed, provided that the Company files its Form 10-K and Form 10-Q on or before August 15, 2006 and demonstrated compliance with all other requirements for continued listing on The Nasdaq National Market.

On June 27, 2006, the Company signed an agreement to sell its car wash in Norristown, Pennsylvania for $2 million cash. Among other items, the agreement calls for the closing to occur by September 10, 2006.

On July 12, 2006, the Company received an updated letter from GMAC granting a waiver of acceleration related to non-compliance with its debt coverage ratio covenant requirement and its delinquency in providing the Company's year end audited financial statements. The waiver was granted as of December 31, 2005, and for measurement periods through April 1, 2007.

21. Selected Quarterly Financial Information (In thousands, except per share information) (Unaudited)

Year Ended December 31, 2005

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Revenues	$ 16,851	$ 18,773	$ 16,086	$ 16,532	$ 68,242
Gross profit	$ 4,577	$ 5,381	$ 4,004	$ 4,501	$ 18,463
Net income (loss)	$ 11	$ 439	$ (1,128)	$ (4,342)	$ (5,020)
Diluted net income (loss) per share	$ -	$ 0.03	$ (0.07)	$ (0.28)	$ (0.33)

Year Ended December 31, 2004

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Revenues	$ 12,675	$ 12,605	$ 16,647	$ 15,720	$ 57,647
Gross profit	$ 3,677	$ 3,459	$ 4,157	$ 4,305	$ 15,598
Net income (loss)	$ 217	$ (14)	$ (229)	$ (6,384)	$ (6,410)
Diluted net income (loss) per share	$ 0.02	$ -	$ (0.02)	$ (0.44)	$ (0.47)

Year Ended December 31, 2003

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Revenues	$ 12,611	$ 12,317	$ 11,897	$ 12,171	$ 48,996
Gross profit	$ 3,680	$ 3,387	$ 2,949	$ 3,168	$ 13,184
Net income (loss)	$ 342	$ (88)	$ (182)	$ (3,605)	$ (3,533)
Diluted net income (loss) per share	$ 0.03	$ (0.01)	$ (0.01)	$ (0.29)	$ (0.28)

In the fourth quarter of 2004, the Company recorded an adjustment to reflect the appropriate balances for certain assets classified as buildings and leasehold improvements that had been depreciated using incorrect useful lives. Specifically, the Company recognized $338,000 in additional depreciation and amortization expense in its consolidated statement of operation for the quarter ended December 31, 2004 to correct the aforementioned error in accounting. We decided to record the correction in the current period and not restate our previously issued financial statements after taking into consideration (i) that the adjustment, net of applicable income taxes, did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; and (ii) that the cumulative impact of the adjustment on stockholders' equity was not material to the financial statements of prior interim or annual periods.

EXHIBIT INDEX

Exhibit No.	Description
10.176	Compensation Arrangements with Certain Executive Officers and Directors
10.179	Note Modification Agreement dated December 1, 2005 between the Company, its subsidiary Mace Security Products, Inc. and JPMorgan Chase Bank, N.A. in the amount of $500,000.
11	Statement Re: Computation of Per Share Earnings
21	Subsidiaries of the Company
23.1	Consent of Grant Thornton LLP
24	Power of Attorney (included on signature page)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant

	to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Global Truck Wash Facility Acquisition Agreement dated December 31, 2005, between Eagle United Truck Wash, LLC and Mace Truck Wash, Inc.

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