

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

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934
For the Fiscal Year Ended December 31, 2006

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Transition Period from _____ to _____

Commission File Number 1-5581

watsco

WATSCO, INC.

(Exact name of registrant as specified in its charter)

FLORIDA
(State or other jurisdiction of
incorporation or organization)

59-0778222
(I.R.S. Employer
Identification No.)

2665 South Bayshore Drive, Suite 901, Coconut Grove, FL 33133
(Address of principal executive offices, including zip code)

(305) 714-4100
(Registrant's telephone number, including area code)

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common stock, \$.50 par value	New York Stock Exchange
Class B common stock, \$.50 par value	American Stock Exchange

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. YES NO

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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in 12b-2 of the Securities Exchange Act of 1934). Large accelerated filer Accelerated filer Non-accelerated filer

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

The aggregate market value of the registrant's voting stock (common stock) held by non-affiliates of the registrant as of June 30, 2006, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$1,446 million, based on the closing sale price of the registrant's common stock on that date. For purposes of determining this number all executive officers and directors of the registrant as of June 30, 2006 are considered to be affiliates of the registrant. This number is provided only for the purposes of this report on Form 10-K and does not represent an admission by either the registrant or any such person as to the status of such person.

The number of shares of common stock outstanding as of February 15, 2007 was 24,147,428 shares of Common stock, excluding treasury shares of 5,985,950, and 3,702,519 shares of Class B common stock, excluding treasury shares of 48,263.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Parts I and II is incorporated by reference from the Annual Report to Shareholders for the year ended December 31, 2006, attached hereto as Exhibit 13. The information required by Part III (Items 10, 11, 12, 13 and 14) will be incorporated by reference from the Registrant's definitive proxy statement (to be filed pursuant to Regulation 14A).

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WATSCO, INC.

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on Form 10-K
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PART I

ITEM 1. BUSINESS

General

Watsco, Inc. and its subsidiaries (collectively, “Watsco”, which may be referred to as *we*, *us* or *our*) was incorporated in 1956 and is the largest distributor of air conditioning, heating, and refrigeration equipment and related parts and supplies (“HVAC”) in the United States. We presently operate from 380 locations in 32 states. Our revenues have increased from \$80 million in 1989 to over \$1.8 billion in 2006 via a strategy of acquiring companies with established market positions and subsequently building revenue and profit growth from a combination of adding locations, products, services and other initiatives.

Our principal executive offices are located at 2665 South Bayshore Drive, Suite 901, Coconut Grove, Florida 33133, and our telephone number is (305) 714-4100. Our website address on the Internet is www.watsco.com and e-mails may be sent to info@watsco.com.

Residential Central Air Conditioning, Heating and Refrigeration Industry

The HVAC distribution industry is highly fragmented with over 1,300 distribution companies. The industry is well-established having its primary period of growth during the post-World War II era with the advent of affordable central air conditioning and heating systems for residential applications.

Based on data published by the Air Conditioning and Refrigeration Institute (“ARI”), the Gas Appliance Manufacturers Association and other available data, we estimate the market for residential central air conditioning, heating and refrigeration equipment and related parts and supplies in the United States is approximately \$26 billion with unitary equipment shipments having grown at a compounded annual rate of 3.4% since 1996. Residential central air conditioners are manufactured primarily by seven major companies that together account for approximately 90% of all units shipped in the United States each year. These companies are: Carrier Corporation (“Carrier”), a subsidiary of United Technologies Corporation, Goodman Manufacturing Corporation (“Goodman”), Rheem Manufacturing Company (“Rheem”), American Standard Companies Inc. (“American Standard”), York International Corporation (“York”), a subsidiary of Johnson Controls, Inc., Lennox International, Inc. (“Lennox”) and Nordyne Corporation (“Nordyne”), a subsidiary of Nortek Corporation. These manufacturers distribute their products through a combination of factory-owned and independent distributors who, in turn, supply the equipment and related parts and supplies to contractors and dealers nationwide that sell to and install the products for the consumer.

Residential central air conditioning and heating equipment is sold to both the replacement and the homebuilding markets. The replacement market has increased substantially in size and importance over the past several years as a result of the aging of the installed base of residential central air conditioners and furnaces, the introduction of new energy efficient models, the remodeling and expansion of existing homes, the addition of central air conditioning to homes that previously had only heating products and the consumers’ overall unwillingness to live without air conditioning or heating products. According to industry data published by the Air Conditioning & Refrigeration Institute, over 100 million central air conditioning units and furnaces have been installed in the United States in the past 20 years. Many units installed during this period have reached the end of their useful lives, thus providing a growing and substantial replacement market. The mechanical life of central air conditioning and furnaces varies by geographical region due to usage and is estimated to range from 8 to 20 years.

We also sell products to the refrigeration market. Such products include condensing units, compressors, evaporators, valves, refrigerant, walk-in coolers and ice machines for industrial and commercial applications. We distribute products manufactured by Copeland Compressor Corporation, a subsidiary of Emerson Electric Co., E. I. Du Pont De Nemours and Company, Tecumseh Products Company and The Manitowoc Company, Inc.

Business Strategy

We have a proven “buy and build” strategy for long-term growth. The “buy” component of the strategy focuses on acquiring market leaders at attractive valuations, either expanding into new geographic areas or gaining further market share in existing markets. We follow a disciplined, conservative approach that looks for opportunities that fit well-defined financial and strategic criteria. The “build” component of the strategy is focused on the institution of a growth culture at acquired companies, the addition of products and locations to better serve our customers, the exchange of ideas and business concepts amongst the executive management team and

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investing in new technology as a competitive advantage. Newly acquired businesses are able to access our capital resources and established vendor relationships to provide an expanded array of product lines on the most favorable terms and conditions with an intensified commitment to service.

Strategy in Existing Markets

Our strategy for growth in existing markets focuses on customer service and product expansion to satisfy the needs of the higher growth, higher margin replacement market, where customers generally demand immediate, convenient and reliable service. In response to this need, our focus is to (i) offer broad product lines, including the necessary equipment, parts and supplies to enable a contractor to install or repair a central air conditioner, furnace or refrigeration system, (ii) maintain multiple warehouse locations for increased customer convenience, (iii) maintain well-stocked inventories to ensure that customer orders are filled in a timely manner, (iv) provide a high degree of technical expertise at the point of sale and (v) develop and implement technological strategies to further enhance customer service capabilities. We believe these concepts provide a competitive advantage over smaller, less-capitalized competitors who are unable to commit resources to open additional locations, implement technological business solutions, provide the same variety of products, maintain the same inventory levels or attract the wide range of expertise that is required to support a diverse product offering. We also believe that in some geographic areas we have a competitive advantage over factory-operated distributor networks who typically do not maintain as diversified inventories of parts and supplies and whose fewer number of warehouse locations make it more difficult to meet the time-sensitive demands of the replacement market.

In addition to the replacement market, we sell to the homebuilding market, including both traditional site-built homes and manufactured housing. We believe our reputation for reliable, high-quality service and relationships with contractors, who may serve both the replacement and new construction markets, allow us to compete effectively in these markets.

Acquisition Strategy

Our acquisition strategy is focused on acquiring businesses that complement our current presence in existing markets or establishing a presence in new markets. Since 1989, we have acquired 51 HVAC distribution businesses, four of which currently operate as primary operating subsidiaries. The other smaller distributors acquired have been integrated into or are under the management of the primary operating subsidiaries. We continue to pursue additional strategic acquisitions to allow further penetration in existing markets and expand into new geographic markets.

Product Line Expansion

We actively seek new or expanded territories of distribution from the key equipment suppliers. Significant relationships currently exist with Rheem, Carrier, Nordyne, Goodman, American Standard and Lennox. We continually evaluate new parts and supply products to support equipment sales and further enhance service to our customers. The initiative includes increasing the product offering with existing vendors and identifying new product opportunities through traditional and non-traditional supply channels. We have also introduced private-label products as a means to obtain market share and grow revenues. We believe that the private-label brand products complement the existing offerings at the selected locations based on their particular market position, price-point and customer needs.

Operating Philosophy

Our subsidiaries operate in a manner that recognizes the long-term relationships established between the distributors and their customers. Generally, the identity and culture of acquired businesses continue by retaining their historical trade-name, management team and sales organization, and by continuing the product brand-name offerings. We believe this strategy builds on the value of the acquired operations by creating additional sales opportunities and is an attractive exit strategy for the existing ownership of the long-standing distribution companies targeted for acquisition.

A specialized functional support staff is maintained at our corporate headquarters to support the subsidiaries' strategies for growth in their respective markets. Such functional support includes specialists in finance, accounting, product procurement, treasury and working capital management, tax planning, risk management and safety. Certain general and administrative expenses are targeted for cost savings that leverage the overall business volume and improve operating efficiencies.

Technology

Our technology initiatives include: (i) implementation of effective point-of-sale systems that allow timely and effective customer service, including up-to-date pricing and inventory availability, (ii) enabling connectivity with our suppliers and by our customers to the relevant components of our subsidiaries' business software and (iii) a web site, ACDocor.com, which provides homeowners and businesses useful information and a variety of services.

DESCRIPTION OF BUSINESS

Products

Watsco sells an expansive line of products and maintains a diverse mix of inventory to meet its customers' immediate needs and seeks to provide products a contractor would generally require when installing or repairing a central air conditioner, furnace or refrigeration system. The cooling capacity of air conditioning units is measured in tons. One ton of cooling capacity is equivalent to 12,000 BTUs and is generally adequate to air condition approximately 500 square feet of residential space. The products we distribute consist of: (i) equipment, including residential central air conditioners ranging from 1-1/2 to 5 tons, light commercial air conditioners ranging up to 20 tons, gas, electric and oil furnaces ranging from 50,000 to 150,000 BTUs, commercial air conditioning and heating equipment and systems ranging from 5 to 25 tons, and other specialized equipment; (ii) parts, including replacement compressors, evaporator coils, motors and other component parts; and (iii) supplies, including thermostats, insulation material, refrigerants, ductwork, grills, registers, sheet metal, tools, copper tubing, concrete pads, tape, adhesives and other ancillary supplies.

Sales of air conditioning and heating equipment accounted for approximately half of our distribution revenues for both years ended December 31, 2006 and 2005; and sales of parts and supplies (currently sourced from over 600 vendors) comprised the other half of our revenues for both such periods as well.

Distribution and Sales

We currently operate from 380 locations, a vast majority of which are located in regions that we believe have favorable demographic trends. We maintain large inventories at each warehouse location, which is accomplished by transporting inventory between locations daily and either directly delivering products to customers using one of our 826 trucks or by making products available for pick-up at the location nearest to the customer. Watsco has approximately 365 commissioned salespeople, averaging 11 years or more of experience in the air conditioning, heating and refrigeration distribution industry.

Markets

Watsco's network serves 32 states from these 380 locations. Primary markets include (the number of locations in the state are in parentheses): Florida (75), Texas (63), Georgia (34), California (30) and North Carolina (28). Locations also reside in Tennessee, South Carolina, Mississippi, Louisiana, Virginia, Alabama, Arizona, Massachusetts, Arkansas, Missouri, Kansas, Oklahoma, Iowa, Kentucky, Maine, New Hampshire, New York, South Dakota, Connecticut, Maryland, Nebraska, Nevada, New Jersey, North Dakota, Rhode Island, Vermont and Illinois. Products are sold on an export-only basis to portions of Latin America and the Caribbean Basin. Export sales are less than 1% of total revenues.

Customers and Customer Service

We sell to contractors and dealers who service the replacement and new construction markets for residential and light commercial central air conditioning, heating and refrigeration systems and we currently serve over 40,000 customers. No single customer in 2006, 2005 or 2004 represented more than 2% of consolidated revenues. We focus on providing products where and when the customer needs them, technical support by phone or on site as required, and quick and efficient service at the locations. Increased customer convenience is also provided through e-commerce, which allows customers to access information on-line 24 hours a day, 7 days a week to search for desired products, verify inventory availability, obtain pricing, place orders, check order status, schedule pickup or delivery times and make payments. We believe we successfully compete with other distributors primarily on the basis of an experienced sales organization, strong service support, high quality reputation and broad product lines.

Key Equipment Suppliers

Significant relationships are maintained with Rheem, Carrier, Nordyne, Goodman, American Standard and Lennox, each a leading manufacturer of residential central air conditioning and heating equipment in the United States. Each manufacturer has a well-established reputation of producing high-quality, competitively priced products. The manufacturers' current product offerings, quality, serviceability and brand-name recognition allow us to operate favorably against our competitors. To maintain brand-name recognition, the manufacturers provide national advertising and participate with us in cooperative advertising programs and promotional incentives that are targeted to both contractors and end-users. It is estimated that the replacement market currently accounts for approximately two-thirds of industry sales in the United States and is expected to increase as units installed in the past 20 years wear out and get replaced or updated to more energy-efficient models.

Approximately 47%, 48% and 45% of purchases in 2006, 2005 and 2004, respectively, were made from the seven key equipment suppliers. The largest supplier accounted for 17% of all purchases made in each of the years ended 2006, 2005 and 2004. A

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significant interruption in the delivery of these products could impair our ability to continue to maintain current inventory levels and could adversely affect our financial results. Future financial results are also materially dependent upon the continued market acceptance of these manufacturers' products and their ability to continue to manufacture products that comply with laws relating to environmental and efficiency standards. We believe that sales of other complementary equipment products and continued emphasis to expand sales of parts and supplies are mitigating factors against such risks.

Distribution Agreements

Distribution agreements have been executed with six key equipment suppliers, either on an exclusive or non-exclusive basis, for terms generally ranging from one to ten years. Certain of the distribution agreements contain provisions that restrict or limit the sale of competitive products in the markets served. Other than the markets where such restrictions and limitations may apply, we may distribute other manufacturers' lines of air conditioning or heating equipment.

Seasonality

Sales of residential central air conditioners, heating equipment and parts and supplies have historically been seasonal. See "Business Risk Factors" in Item 1A.

Competition

We operate in highly competitive environments. See "Business Risk Factors" in Item 1A.

Employees

There were approximately 3,300 employees as of December 31, 2006, substantially all of which are non-union employees. Most of these employees are employed on a full-time basis, and relations with employees are good.

Order Backlog

Order backlog is not a material aspect of the business and no material portion of the business is subject to government contracts.

Government Regulations, Environmental and Health and Safety Matters

Our industry and business are subject to federal, state and local laws and regulations relating to the generation, storage, handling, emission, transportation and discharge of materials into the environment. These include laws and regulations implementing the Clean Air Act, relating to minimum energy efficiency standards of HVAC systems and the production, servicing and disposal of certain ozone-depleting refrigerants used in such systems, including those established at the Montreal Protocol in 1992 concerning the phase-out of CFC-based refrigerants on products manufactured after January, 2010. We are also subject to regulations concerning the transport of hazardous materials, including regulations adopted pursuant to the Motor Carrier Safety Act of 1990. Our operations are also subject to health and safety requirements including the Occupational, Safety and Health Act (OSHA). Management believes that the business is operated in substantial compliance with all applicable federal, state and local provisions relating to the protection of the environment, transport of hazardous materials and health and safety requirements.

Our industry and business was also subject to a Department of Energy mandate that required, effective January 23, 2006, that our key equipment suppliers manufacture products with a higher standard of energy efficiency. Prior to January 23, 2006, the minimum standard for energy efficiency as measured by industry guidelines was 10 SEER (seasonal energy efficiency rating, the metric used to measure energy efficiency). On the effective date, the new standard increased the minimum allowed efficiency to 13 SEER (a 30% improvement in efficiency). The transition of products from the current standard to the new standard took place during 2006, as 13 SEER products were introduced and became fully available to consumers.

Non-U.S. Operations

All of our operations are within the United States. We do not have any international operations. Export sales are less than 1% of total revenues.

ADDITIONAL INFORMATION

Filings with the Securities and Exchange Commission

As a public company, we regularly file reports and proxy statements with the Securities and Exchange Commission (“SEC”). These reports are required by the Securities Exchange Act of 1934 and include, but are not limited to:

- annual reports on Form 10-K;
- quarterly reports on Form 10-Q;
- current reports on Form 8-K; and
- proxy statements on Schedule 14A.

The public may read and copy any of the materials we file with the SEC at the SEC’s Public Reference Room at 100 F. Street N.E., Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site at www.sec.gov that contains the reports, proxy and information statements, and other information that we file electronically.

Our Internet website address is www.watsco.com. We make available free of charge on or through the website our SEC filings as soon as reasonably practicable after the materials are electronically filed with the SEC. Other reports filed with the SEC under the Securities Exchange Act of 1934, as amended, are also available including the proxy statements and reports filed by officers and directors under Section 16(a) of that Act. These reports may be found on the website by selecting the option entitled “SEC FILINGS” under the “INVESTOR RELATIONS” area of the website. The information on our website is not incorporated by reference into this Annual Report on Form 10-K.

Corporate Governance

An “Employee Code of Business Ethics and Conduct” is maintained that is applicable to all employees and additionally a “Code of Conduct for Senior Executives” that is applicable to members of the Board of Directors, executive officers and senior operating and financial personnel. These codes require continued observance of high ethical standards such as honesty, integrity and compliance with laws. These codes are publicly available on the website by selecting the option entitled “CODE OF CONDUCT” under the “CAREERS” area of the website. These materials may also be requested in print by writing to Watsco, Inc., Investor Relations, 2665 South Bayshore Drive, Suite 901, Coconut Grove, FL 33133.

ITEM 1A. RISK FACTORS

Business Risk Factors

Supplier Concentration

We maintain distribution agreements with the key equipment suppliers, either on an exclusive or non-exclusive basis, for terms generally ranging from one to ten years. Certain of the distribution agreements contain provisions that restrict or limit the sale of competitive products in the markets served. Other than the markets where such restrictions and limitations may apply, we may distribute other manufacturers’ lines of air conditioning or heating equipment. Purchases from these suppliers comprised 47% of all purchases made in 2006 with the largest supplier accounting for 17% of all purchases made in 2006. Any significant interruption by the manufacturers or a termination of a distribution agreement could temporarily disrupt the operations of certain subsidiaries. Future results of operations are also materially dependent upon the continued market acceptance of these manufacturers’ products and their ability to continue to manufacture products that comply with laws relating to environmental and efficiency standards.

Competition

We operate in highly competitive environments. We compete with a number of distributors and also with several air conditioning and heating equipment manufacturers that distribute a significant portion of their products through their own distribution organizations in certain markets. Competition within any given geographic market is based upon product availability, customer service, price and quality. Competitive pressures or other factors could cause our products or services to lose market acceptance or result in significant price erosion, all of which would have a material adverse effect on profitability.

Seasonality

Sales of residential central air conditioners, heating equipment and parts and supplies have historically been seasonal. Furthermore, profitability can be impacted favorably or unfavorably based on the severity or mildness of weather patterns during summer or winter selling seasons. Demand related to the residential central air conditioning replacement market is highest in the second and third

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quarters with demand for heating equipment usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly even during the year except for dependence on housing completions and related weather and economic conditions.

Risks Inherent in Acquisitions

As part of our strategy, we intend to pursue additional acquisitions of complementary businesses. If we complete future acquisitions, we may be required to incur or assume additional debt and/or issue additional shares of our common stock as consideration, which will dilute our existing stockholders' ownership interest and may affect our results of operations. Growth through acquisitions involves a number of risks, including the following:

- the ability to identify and consummate complementary acquisition candidates;
- the successful operation and/or integration of acquired companies in an effective manner;
- diversion of management's attention from other daily functions;
- issuance by us of equity securities that would dilute ownership of our existing stockholders;
- incurrence and/or assumption of significant debt and contingent liabilities; and
- loss of key employees and/or customer relationships of the acquired companies.

Dependence on Key Personnel

We are highly dependent on the skills, experience and services of key personnel. The loss of key personnel could have a material adverse effect on our business, operating results or financial condition. Our potential growth and expansion are expected to place increased demands on our management skills and resources. Therefore, our success also depends upon our ability to recruit, hire, train and retain additional skilled and experienced management personnel. Employment and retention of qualified personnel is important due to the competitive nature of our industry.

General Risk Factors

Goodwill and Intangibles

At December 31, 2006, goodwill and intangibles represented approximately 23% of total assets. Goodwill and indefinite life intangibles are no longer amortized and are subject to impairment testing at least annually using a fair value based approach. The identification and measurement of impairment involves the estimation of the fair value of reporting units. Accounting for impairment contains uncertainty because management must use judgment in determining appropriate assumptions to be used in the measurement of fair value. The estimates of fair value of reporting units are based on the best information available as of the date of the assessment and incorporate management assumptions about expected future cash flows and contemplate other valuation techniques. Future cash flows can be affected by changes in industry or market conditions.

The recoverability of goodwill and indefinite life intangibles is evaluated at least annually and when events or changes in circumstances indicate that the carrying amount of goodwill and indefinite life intangibles may not be recoverable. Although no impairment has been recorded to date, there can be no assurances that future impairments will not occur.

Risks Related to Insurance Coverage

We carry general liability, comprehensive property damage, workers' compensation and other insurance coverages that management considers adequate for the protection of its assets and operations. There can be no assurance, however, that the coverage limits of such policies will be adequate to cover losses and expenses for lawsuits brought or which may be brought against us. A loss in excess of insurance coverages could have a material adverse effect on our financial position and/or profitability. Certain self-insurance risks for casualty insurance programs and health benefits are retained and reserves are established based on claims filed and estimates of claims incurred but not yet reported. Assurance cannot be provided that actual claims will not exceed present estimates. Exposure to catastrophic losses has been limited by maintaining excess and aggregate liability coverages and implementing loss control programs.

Control by Existing Shareholder

As of December 31, 2006, Albert H. Nahmad, Watsco's Chairman and Chief Executive Officer, and a limited partnership controlled by him, collectively had beneficial ownership of approximately 57% of the combined voting power of the outstanding Common stock and Class B common stock. Based on Mr. Nahmad's stock ownership and the stock ownership of the limited partnership controlled by him, Mr. Nahmad has the voting power to elect all but three members of the nine-person Board of Directors and to control most corporate actions requiring shareholder approval.

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Information about Forward-Looking Statements

This Form 10-K contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, “forward-looking statements” as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) business and acquisition strategies, (ii) potential acquisitions, (iii) financing plans and (iv) industry, demographic and other trends affecting Watsco’s financial condition or results of operations. These forward-looking statements are based largely on management’s current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including:

- general economic conditions affecting general business spending,
- consumer spending,
- consumer debt levels,
- seasonal nature of product sales,
- weather conditions,
- effects of supplier concentration,
- competitive factors within the HVAC industry,
- insurance coverage risks,
- prevailing interest rates, and
- the continued viability of Watsco’s business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if substantially realized, that the information will have the expected consequences to or effects on Watsco or its business or operations. A discussion of certain of these risks and uncertainties that could cause actual results to differ materially from those predicted in such forward-looking statements is included in Watsco’s Annual Report to Shareholders for the fiscal year ended December 31, 2006 in the section captioned “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” which section has been incorporated in the Form 10-K by reference. Forward-looking statements speak only as of the date the statement was made. Watsco assumes no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our main properties include warehousing and distribution facilities, trucks and administrative office space.

Warehousing and Distribution Facilities

At December 31, 2006, we operated 380 warehousing and distribution facilities across 32 states in the United States having approximately 7.9 million square feet of space in the aggregate of which approximately 7.5 million square feet is leased. The majority of these leases are for terms of three to five years. We believe that our facilities are generally sufficient to meet our present operating needs.

Trucks

At December 31, 2006, we operated 826 ground transport vehicles, including delivery and pick-up trucks, vans and tractors. Of this number, 534 trucks were leased and the rest were owned. We believe that the present size of our truck fleet is adequate to support our operations.

Administrative and Other Properties and Facilities

Senior management and a functional support staff is located at Watsco’s corporate headquarters in Coconut Grove, Florida in approximately 6,000 square feet of owned space. In addition to the corporate headquarters, we also have 11 other locations, with an aggregate of approximately 25,000 square feet, all of which are leased. The majority of these leases are for terms of three to five years.

During 2006, our capital expenditures were \$10 million.

ITEM 3. LEGAL PROCEEDINGS

We are involved in litigation incidental to the operation of our business. We vigorously defend all matters in which Watsco or its subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments. Although the adequacy of existing insurance coverage or the outcome of any legal proceedings cannot be predicted with certainty, we do not believe the ultimate liability associated with any claims or litigation will have a material impact to our financial condition or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the year ended December 31, 2006.

PART II

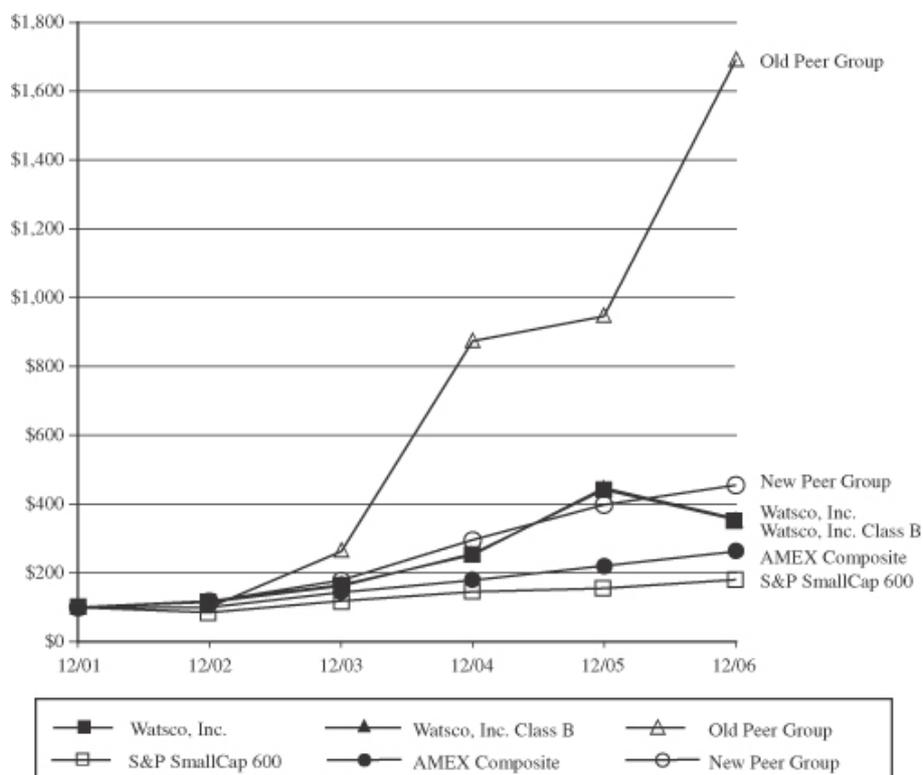
ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Page 41 of the 2006 Annual Report contains “Information on Common Stock,” which identifies the market on which Watsco’s common stocks are being traded and contains the high and low sales prices and dividend information for the years ended December 31, 2006 and 2005, and is incorporated herein by reference.

Performance Graph

The following graph compares the cumulative 5-year total return attained by shareholders on Watsco, Inc.’s Common stock and Class B common stock relative to the cumulative total returns of the AMEX Composite index, the S & P Smallcap 600 index and two customized peer groups of companies that includes a new peer group of six companies, which are: Beacon Roofing Supply Inc, Goodman Global Inc, Interline Brands Inc, Lennox International Inc, Pool Corp. and Wesco International Inc; and the old peer group of one company which is ACR Group Inc. We determined to use the new peer group this year because we believe that the new peer group more closely reflects our business and, as a result, provides a more meaningful comparison of stock performance. In accordance with Securities and Exchange Commission rules, the graph includes both the old peer group and the new peer group. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock, in each index and in each of the peer groups on 12/31/2001 and its relative performance is tracked through 12/31/2006.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Watsco, Inc., The AMEX Composite Index,
The S & P Smallcap 600 Index, A New Peer Group And An Old Peer Group



	12/01	12/02	12/03	12/04	12/05	12/06
Watsco, Inc.	100.00	116.19	163.09	256.27	441.61	354.12
Watsco, Inc. Class B	100.00	118.56	166.15	252.80	445.94	357.07
AMEX Composite	100.00	100.00	144.57	178.46	220.35	262.17
S & P Smallcap 600	100.00	85.37	118.48	145.32	156.48	180.14
Old Peer Group	100.00	100.00	262.86	871.43	942.86	1685.71
New Peer Group	100.00	117.12	179.34	296.51	397.08	453.86

The stock price performance included in this graph is not necessarily indicative of future stock price performance.

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Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Watsco's Board of Directors has authorized the repurchase (originally adopted in September 1999), at management's discretion, of 7.5 million shares of common stock to be repurchased in the open market or via private transactions. Through December 31, 2006, 6.0 million shares of Common and Class B common stock have been repurchased at a cost of \$100.2 million since the inception of the program. The remaining 1.5 million shares authorized for repurchase are subject to certain restrictions included in the debt agreements. During the quarter ended December 31, 2006, there were no purchases of our equity securities made by us or on our behalf by any "affiliated purchaser" (as such term is defined in Rule 10b-18(a)(3) of the Securities Act of 1933, as amended).

Recent Sales of Unregistered Securities

No sales of unregistered securities were made during the fourth quarter of the year ended December 31, 2006.

Dividends

Cash dividends of \$.95 per share, \$.62 per share and \$.38 per share of Common stock and Class B common stock were paid in 2006, 2005 and 2004, respectively. In February 2007, Watsco's Board of Directors approved an increase in the quarterly cash dividend to 33 cents per share from 25 cents per share. Future dividends will be at the sole discretion of the Board of Directors and will depend upon such factors as profitability, financial condition, cash requirements, restrictions existing under the debt agreements, future prospects and other factors deemed relevant by Watsco's Board of Directors.

ITEM 6. SELECTED FINANCIAL DATA

Page 42 of the 2006 Annual Report contains "Selected Consolidated Financial Data" and is incorporated herein by reference.

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

Pages 9 through 17 of the 2006 Annual Report contain "Management's Discussion and Analysis of Financial Condition and Results of Operations" and is incorporated herein by reference.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Page 15 of the 2006 Annual Report contains "Quantitative and Qualitative Disclosures About Market Risk" and is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Pages 19, 20 and 22 through 39 of the 2006 Annual Report contain the 2006 and 2005 Consolidated Balance Sheets and other consolidated financial statements for the years ended December 31, 2006, 2005 and 2004, together with the reports thereon (for the applicable periods covered by their reports) of Grant Thornton LLP dated March 1, 2007 and Ernst & Young LLP dated March 14, 2005, and are incorporated herein by reference.

Page 40 of the 2006 Annual Report contains "Selected Quarterly Financial Data" for 2006 and 2005 and is incorporated herein by reference.

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

There were no disagreements with accountants on accounting or financial disclosures during the last three fiscal years. On August 18, 2005, the Audit Committee of the Company's Board of Directors dismissed Ernst & Young LLP as the Company's independent registered public accounting firm and engaged Grant Thornton LLP to serve as the Company's new independent registered public accounting firm. For more information with respect to this matter, see our Report on Form 8-K filed on August 24, 2005.

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ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer, Senior Vice President and Chief Financial Officer have evaluated the effectiveness of Watsco's "disclosure controls and procedures" (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) as of December 31, 2006, and each has concluded that such disclosure controls and procedures are effective to ensure that information required to be disclosed in our periodic reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission's rules and regulations.

Management's Report on Internal Control Over Financial Reporting

Pages 18 and 21 of the 2006 Annual Report contain "Management's Report on Internal Control Over Financial Reporting" and the report thereon of Grant Thornton LLP dated March 1, 2007, and are incorporated herein by reference.

Changes in Internal Control Over Financial Reporting

We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout the Company. However, there have been no changes in internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, Watsco's internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

This part of Form 10-K, which includes Items 10 through 14, is omitted because Watsco will file definitive proxy material pursuant to Regulation 14A not more than 120 days after the close of Watsco's year-end, which proxy material will include the information required by Items 10 through 14 and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

	<u>Page No. in Annual Report</u>
(1) Consolidated Financial Statements (incorporated by reference from the 2006 Annual Report of Watsco, Inc.):	
Management's Report on Internal Control Over Financial Reporting	18
Report of Independent Registered Public Accounting Firm on the Financial Statements – Grant Thornton LLP	19
Report of Independent Registered Public Accounting Firm on the Financial Statements – Ernst & Young LLP	20
Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting – Grant Thornton LLP	21
Consolidated Statements of Income for the years ended December 31, 2006, 2005 and 2004	22
Consolidated Balance Sheets as of December 31, 2006 and 2005	23
Consolidated Statements of Shareholders' Equity for the years ended December 31, 2006, 2005 and 2004	24
Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004	25
Notes to Consolidated Financial Statements	26-39
Selected Quarterly Financial Data (Unaudited)	40

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Page No. in
Form 10-K

(2)	Consolidated Financial Statement Schedule for the three years ended December 31, 2006, 2005 and 2004	
	Report of Independent Registered Public Accounting Firm on Schedule – Grant Thornton LLP	S-1
	Report of Independent Registered Public Accounting Firm on Schedule – Ernst & Young LLP	S-2
	Schedule II. Valuation and Qualifying Accounts	S-3

All other schedules have been omitted since the required information is not present, or is not present in amounts sufficient to require submission of the schedule, or because the information required is included in the consolidated financial statements or notes thereto.

(3)	Exhibits: The following list of exhibits includes exhibits submitted with this Form 10-K as filed with the SEC and those incorporated by reference to other filings.	
3.1	Watsco's Amended and Restated Articles of Incorporation (filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2001 and incorporated herein by reference).	
3.2	Watsco's Bylaws (filed as Exhibit 3.2 to the Annual Report on Form 10-K for the fiscal year ended January 31, 1985 and incorporated herein by reference).	
4.1	Specimen form of Class B Common Stock Certificate (filed as Exhibit 4.6 to the Registration Statement on Form S-1 (No. 33-56646) and incorporated herein by reference).	
4.2	Specimen form of Common Stock Certificate (filed as Exhibit 4.4 to the Annual Report on Form 10-K for the fiscal year ended December 31, 1994 and incorporated herein by reference).	
10.1	Watsco, Inc. Amended and Restated 1991 Stock Option Plan (filed as Exhibit 4.23 to the Registration Statement on Form S-8 (333-82011) and incorporated herein by reference). +	
10.2	Watsco, Inc. Amended and Restated Profit Sharing Retirement Plan and Trust Agreement dated October 21, 1994 (filed as Exhibit 10.25 to the Annual Report on Form 10-K for the year ended December 31, 1994 and incorporated herein by reference). +	
10.3	Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.20 to the Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1996 and incorporated herein by reference). +*	
10.4	Watsco, Inc. 2001 Incentive Compensation Plan (filed as Appendix B to the Definitive Proxy Statement for the year ended December 31, 2000 and incorporated herein by reference). +	
10.5	First Amendment dated January 1, 2001 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.13 to the Annual Report on Form 10-K for the year ended December 31, 2000 and incorporated herein by reference). +*	
10.6	Second Amendment dated January 1, 2002 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.15 to the Annual Report on Form 10-K for the year ended December 31, 2001 and incorporated herein by reference). +*	
10.7	Third Amendment dated February 10, 2003 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.11 to the Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference). +*	

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- 10.8 Fourth Amendment dated January 1, 2004 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2004 and incorporated herein by reference). +*
- 10.9 Fifth Amendment dated January 1, 2005 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2005 and incorporated herein by reference). +*
- 10.10 Revolving Credit Agreement dated as of December 10, 2004 among Watsco, Inc., as borrower, the Lenders from Time to Time Party and SunTrust Bank as administrative agent (filed as Exhibit 10.1 to the Current Report on Form 8-K on December 16, 2004 and incorporated herein by reference).
- 10.11 Second Amended and Restated \$125 million Private Shelf Agreement dated as of December 10, 2004 by and among Watsco, Inc. and the Prudential Insurance Company of America (filed as Exhibit 10.14 to the Annual Report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference).
- 10.12 Termination of Key Executive Deferred Compensation Agreement dated April 4, 2005, between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.1 to the Current Report on Form 8-K on April 4, 2005 and incorporated herein by reference). +*
- 10.13 Amendment No. 1 to Revolving Credit Agreement dated as of December 1, 2005 among Watsco, Inc., as borrower, the Lenders from Time to Time Party and SunTrust Bank as administrative agent (filed as Exhibit 10.13 to the Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference).
- 10.14 First Amendment to Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan dated December 15, 2005 (filed as Exhibit 10.14 to the Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference). +
- 10.15 Amendment to the Watsco, Inc. Profit Sharing Retirement Plan and Trust dated January 1, 2006 (filed as Exhibit 10.15 to the Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference). +
- 10.16 Sixth Amendment dated January 1, 2006 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad (filed as Exhibit 10.16 to the Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference). +*
- 10.17 Watsco, Inc. 2001 Incentive Compensation Plan (filed as Exhibit I to the Definitive Proxy Statement for the year ended December 31, 2005 and incorporated herein by reference). +
- 10.18 Seventh Amendment dated February 22, 2007 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad. +#
- 13. 2006 Annual Report to Shareholders (with the exception of the information incorporated by reference into Items 1, 5, 6, 7 and 8 of this Form 10-K, the 2006 Annual Report to Shareholders is provided solely for the information of the Securities and Exchange Commission and is not deemed “filed” as part of this Form 10-K). #
- 14.1 Watsco, Inc. Employee Code of Business Ethics and Conduct (filed as Appendix C to the Definitive Proxy Statement on Schedule 14A for the year ended December 31, 2002).
- 14.2 Watsco, Inc. Code of Conduct for Senior Executives (filed as Appendix D to the Definitive Proxy Statement on Schedule 14A for the year ended December 31, 2002).
- 16. Letter of Ernst & Young LLP, dated August 24, 2005, regarding change in certifying accountant (filed as Exhibit 16 to the Current Report on Form 8-K on August 18, 2005 and incorporated herein by reference).
- 21. Subsidiaries of the Registrant. #
- 23.1 Consent of Independent Registered Public Accounting Firm – Grant Thornton LLP. #

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23.2	Consent of Independent Registered Public Accounting Firm – Ernst & Young LLP. #
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. #
31.2	Certification of Senior Vice President pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. #
31.3	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 Section 906 of the Sarbanes-Oxley Act of 2002. #
32.2	Certification of Senior Vice President pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. #
32.3	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. #

Note to exhibits:

- # Submitted electronically herewith
- + Compensation Plan or Arrangement
- * Management Contract

SIGNATURES

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

WATSCO, INC.

March 1, 2007

By: /s/ Albert H. Nahmad
Albert H. Nahmad, President

March 1, 2007

By: /s/ Ana M. Menendez
Ana M. Menendez, Chief Financial Officer

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 Registrant and in the capacities and on the dates indicated.

<u>SIGNATURE</u>	<u>TITLE</u>	<u>DATE</u>
<u>/s/ ALBERT H. NAHMAD</u> Albert H. Nahmad	Chairman of the Board and Chief Executive Officer (principal executive officer)	March 1, 2007
<u>/s/ BARRY S. LOGAN</u> Barry S. Logan	Senior Vice President	March 1, 2007
<u>/s/ ANA M. MENENDEZ</u> Ana M. Menendez	Chief Financial Officer (principal accounting officer and principal financial officer)	March 1, 2007
<u>/s/ CESAR L. ALVAREZ</u> Cesar L. Alvarez	Director	March 1, 2007
<u>/s/ FREDERICK H. JOSEPH</u> Frederick H. Joseph	Director	March 1, 2007
<u>/s/ VICTOR M. LOPEZ</u> Victor M. Lopez	Director	March 1, 2007
<u>/s/ PAUL F. MANLEY</u> Paul F. Manley	Director	March 1, 2007
<u>/s/ BOB L. MOSS</u> Bob L. Moss	Director	March 1, 2007
<u>/s/ GEORGE P. SAPE</u> George P. Sape	Director	March 1, 2007
<u>/s/ GARY L. TAPELLA</u> Gary L. Tapella	Director	March 1, 2007
<u>/s/ SHERWOOD M. WEISER</u> Sherwood M. Weiser	Director	March 1, 2007

Report of Independent Registered Public Accounting Firm on Schedule

The Board of Directors and Shareholders of
Watsco, Inc.

We have audited in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated financial statements of Watsco, Inc. and subsidiaries as of December 31, 2006 and 2005 and for each of the two years then ended, referred to in our report dated March 1, 2007 (included within Item 15 in this Form 10-K). Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. Schedule II is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and in our opinion is fairly stated in all material aspects in relation to the basic consolidated financial statements taken as a whole.

/s/ GRANT THORNTON LLP

Miami, Florida
March 1, 2007

Report of Independent Registered Public Accounting Firm on Schedule

The Board of Directors and Shareholders of
Watsco, Inc.

We have audited the consolidated financial statements of Watsco, Inc. and subsidiaries for the year ended December 31, 2004 and have issued our report thereon dated March 14, 2005 (included elsewhere in this Form 10-K). Our audit also included the financial statement schedule for the year ended December 31, 2004, listed in Item 15(2) of this Form 10-K. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP
Certified Public Accountants

Miami, Florida
March 14, 2005

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WATSCO, INC., AND SUBSIDIARIES
SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS
For the Years Ended December 31, 2006, 2005 and 2004
(In thousands)

Allowance for Doubtful Accounts:

BALANCE, December 31, 2003	\$ 3,028
Additions charged to costs and expenses	1,556
Write-offs, net	<u>(2,313)</u>
BALANCE, December 31, 2004	2,271
Additions charged to costs and expenses	1,854
Write-offs, net	<u>(1,106)</u>
BALANCE, December 31, 2005	3,019
Additions charged to costs and expenses	3,461
Write-offs, net	<u>(3,340)</u>
BALANCE, December 31, 2006	<u>\$ 3,140</u>

Valuation Allowance for Deferred Income Taxes:

BALANCE, December 31, 2003	\$ 324
Additions charged to income tax expense	<u>72</u>
BALANCE, December 31, 2004	396
Additions charged to income tax expense	<u>—</u>
BALANCE, December 31, 2005	396
Additions charged to income tax expense	<u>12</u>
BALANCE, December 31, 2006	<u>\$ 408</u>

Exhibit Index

<u>Exhibit Number</u>	<u>Description</u>
10.18	Seventh Amendment dated February 22, 2007 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad.
13	2006 Annual Report to Shareholders (with the exception of the information incorporated by reference into Items 1, 5, 6, 7 and 8 of this Form 10-K, the 2006 Annual Report to Shareholders is provided solely for the information of the Securities and Exchange Commission and is not deemed “filed” as part of this Form 10-K).
21	Subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm – Grant Thornton LLP.
23.2	Consent of Independent Registered Public Accounting Firm – Ernst & Young LLP.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Senior Vice President pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.3	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 Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Senior Vice President pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.3	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SEVENTH AMENDMENT
TO
EMPLOYMENT AGREEMENT**

This Seventh Amendment to Employment Agreement is made and entered into effective as of January 1, 2007, by and between **WATSCO, INC.**, a Florida corporation (hereinafter called the "Company"), and **ALBERT H. NAHMAD** (hereinafter called the "Employee").

RECITALS

WHEREAS, the Company and the Employee entered into an Employment Agreement effective as of January 31, 1996 (the "Employment Agreement") pursuant to which the Employee renders certain services to the Company; and

WHEREAS, the Compensation Committee of the Company's Board of Directors amended the Employment Agreement effective as of January 1, 2001, January 1, 2002, January 1, 2003, January 1, 2004, January 1, 2005 and January 1, 2006; and

WHEREAS, the Compensation Committee of the Company's Board of Directors has determined to increase the Employee's Base Salary from \$960,000 to \$998,000, effective as of January 1, 2007, and has set the targets for the performance based compensation payable by the Company to the Employee for the year 2007; and

WHEREAS, the Company and the Employee now desire to amend Employment Agreement and Exhibit A-1 to the Employment Agreement to reflect the increase in Base Salary and specify the performance based compensation amount payable by the Company to the Employee for the calendar year 2007.

NOW, THEREFORE, in consideration of the mutual promises and covenants set forth in this Seventh Amendment, and other good and valuable consideration, the parties to this Seventh Amendment agree as follows:

1. All capitalized terms in this Seventh Amendment shall have the same meaning as in the Employment Agreement, unless otherwise specified.

2. The first sentence of Section 4 of the Employment Agreement is hereby amended to read as follows:

“Effective as of January 1, 2007, the Company agrees to pay to Employee and Employee agrees to accept from the Company a salary at the annual rate of not less than Nine Hundred Ninety Eight Thousand (\$998,000) Dollars, payable in bi-weekly or monthly installments.”

3. The Employment Agreement is hereby amended by replacing “Exhibit A-1 — 2006 Performance Goals and Performance Based Compensation” with the attached “Exhibit A-1 — 2007 Performance Goals and Performance Based Compensation” thereto.

4. All other terms and conditions of the Employment Agreement shall remain the same.

IN WITNESS WHEREOF, the parties have caused this Seventh Amendment to be duly executed effective as of the day and year first above written.

COMPANY:

WATSCO, INC.

By: /s/ BARRY S. LOGAN

Barry S. Logan, Senior Vice President

EMPLOYEE:

/s/ ALBERT H. NAHMAD

ALBERT H. NAHMAD

EXHIBIT A-1

2007 Performance Goals and Performance Based Compensation

II. Formula

	Performance Based Compensation Formula
A. <u>Earnings Per Share</u>	
For each \$.01 increase	\$ 65,250
B. <u>Increase in Common Stock Price</u>	
(i) If the price of a share of Common Stock on 12/31/07 does not exceed \$47.16	\$ 0
(ii) If the price of a share of Common Stock on 12/31/07 exceeds \$47.16 but does not equal or exceed \$55.00, for each \$0.01 increase in per share price of a share of Common Stock above \$47.16	\$ 1,200
(iii) If the price of a share of Common Stock on 12/31/07 equals or exceeds \$55.00, for each \$0.01 increase in per share price of a share of Common Stock above \$47.16	\$ 1,800

III. Method of Payment

- A. Cash. The Performance Based Compensation determined for 2007 under the formula set forth in Section I above shall be paid in cash if and to the extent such Compensation does not exceed \$5,000,000.
- B. Restricted Stock. If the Performance Based Compensation determined for 2007 under the formula set forth in Section I above exceeds \$5,000,000 (such excess amount being referred to as the "Additional Amount"), the Executive shall be granted a number of shares of restricted Class B Common Stock of the Company (the "Shares") equal to the amount determined by dividing (i) two times the Additional Amount, by (ii) the closing price for the Class B Common Stock of the Company on the American Stock Exchange as of the close of trading on December 31, 2007. The value of any fractional shares shall be paid in cash. The restrictions on the Shares shall lapse on the first to occur of (i) October 15, 2018 (ii) termination of the Executive's employment with the Company by reason of Executive's disability or death, (iii) the Executive's termination of employment with the Company for Good Reason; (iv) the Company's termination of Executive's employment without Cause, or (v) the occurrence of a Change in Control of the Company ("Good Reason", "Cause", and "Change in Control" to be defined in a manner consistent with the most recent grant of Restricted Stock by the Company to the Executive).

IV. 2001 Incentive Compensation Plan

The performance based award and method of payment specified above (the "Award") were made by the Compensation Committee in accordance with Section 8 of the Company's 2001 Incentive Compensation Plan (the "Incentive Plan") and are subject to the limitations contained in Section 5 of the Incentive Plan. The Award is intended to qualify as "performance based compensation" under Section 162(m) of the Internal Revenue Code.

Dated: Effective as of January 1, 2007

/s/ PAUL F. MANLEY

Paul F. Manley, Chairman
Compensation Committee

Acknowledged and Accepted:

/s/ ALBERT H. NAHMAD

Albert H. Nahmad

WATSCO, INC. AND SUBSIDIARIES
SELECTED CONSOLIDATED FINANCIAL DATA

*Years Ended December 31,
(In thousands, except per share data)*

	2006 (1)	2005	2004	2003	2002
OPERATIONS					
Revenues	\$ 1,800,759	\$ 1,682,724	\$ 1,315,024	\$ 1,232,908	\$ 1,181,136
Gross profit	462,900	423,030	336,935	305,083	287,276
Operating income	135,603	116,458	82,052	61,189	50,924
Net income	<u>82,364</u>	<u>70,019</u>	<u>48,105</u>	<u>34,895</u>	<u>28,536</u>
SHARE AND PER SHARE DATA					
Diluted earnings per share	\$ 2.96	\$ 2.52	\$ 1.79	\$ 1.34	\$ 1.07
Cash dividends declared and paid per share:					
Common stock	\$ 0.95	\$ 0.62	\$ 0.38	\$ 0.20	\$ 0.115
Class B common stock	0.95	0.62	0.38	0.20	0.115
Weighted average shares outstanding for diluted earnings per share	27,829	27,769	26,931	26,037	26,674
Common stock outstanding	<u>27,833</u>	<u>27,463</u>	<u>26,855</u>	<u>26,324</u>	<u>26,032</u>
BALANCE SHEET INFORMATION					
Total assets	\$ 711,371	\$ 678,731	\$ 608,289	\$ 535,095	\$ 503,719
Long-term obligations	30,118	40,189	50,155	60,153	80,233
Shareholders' equity	<u>516,386</u>	<u>450,650</u>	<u>402,738</u>	<u>360,869</u>	<u>329,201</u>

- (1) Effective January 1, 2006, the provisions of SFAS No. 123R, "Share-Based Payment", were adopted using the modified prospective transition method. The impact of adopting SFAS No. 123R was a reduction of our net income of \$906 for the year ended December 31, 2006. Also, diluted earnings per share were reduced by \$.03 for the year ended December 31, 2006, as a result of adopting SFAS No. 123R.

WATSCO, INC. AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Company Overview

Watsco, Inc. and its subsidiaries (collectively, "Watsco") was incorporated in 1956 and is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies ("HVAC") in the United States. We presently operate from 380 locations in 32 states.

Revenues primarily consist of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. Selling, general and administrative expenses primarily consist of selling expenses, the largest components of which are salaries, commissions and marketing expenses that tend to be variable in nature and correlate to sales growth. Other significant selling, general and administrative expenses relate to the operation of warehouse facilities, including a fleet of trucks and forklifts and facility rent, which are payable under non-cancelable operating leases.

Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on the severity or mildness of weather patterns during summer or winter selling seasons. Demand related to the residential central air conditioning replacement market is highest in the second and third quarters with demand for heating equipment usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly even during the year except for dependence on housing completions and related weather and economic conditions.

Critical Accounting Policies

Management's discussion and analysis of Watsco's financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. At least quarterly, management reevaluates its judgments and estimates which are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances.

Our significant accounting policies are discussed in Note 1 to the consolidated financial statements. Management believes that the following accounting policies include a higher degree of judgment and/or complexity and, thus, are considered to be critical accounting policies. Management has discussed the development and selection of critical accounting policies with Watsco's Audit Committee of the Board of Directors and the Audit Committee has reviewed the disclosures relating to them.

Allowance for Doubtful Accounts

An allowance for doubtful accounts is maintained for estimated losses resulting from the inability of customers to make required payments. Accounting for doubtful accounts contains uncertainty because management must use judgment to assess the collectibility of these accounts. When preparing these estimates, management considers a number of factors, including the aging of a customer's account, past transactions with customers, creditworthiness of specific customers, historical trends and other information. Our business is seasonal and our customers' businesses are also seasonal. Sales are lowest during the first and fourth quarters and past due accounts receivable balances as a percentage of total trade receivables generally increase during these quarters. We review our accounts receivable reserve policy periodically, reflecting current risks, trends and changes in industry conditions.

The allowance for doubtful accounts was \$3.1 million and \$3.0 million at December 31, 2006 and 2005, respectively, an increase of \$.1 million. The increase from December 31, 2005 is primarily due to an increase in the over 90 day balances. Accounts receivable balances greater than 90 days past due as a percent of accounts receivable at December 31, 2006 increased to 2.1% compared to 1.2% at December 31, 2005. This increase was driven by decreased sales volume. Accounts receivable net write-offs as a percent of sales increased for the year ended December 31, 2006 to .19% compared to .07% for the year ended December 31, 2005. This was primarily the result of a large 2006 write-off related to one customer, as well as lower bad debt recoveries in 2006.

Although we believe the allowance for doubtful accounts is sufficient, if the financial condition of customers were to unexpectedly deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required that could materially impact our consolidated results of operations. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers comprising the customer base and their dispersion across many different geographical regions. Watsco also has access to a credit insurance program which is used as an additional means to mitigate credit risk.

Inventory Valuation

Inventories consist of air conditioning, heating and refrigeration equipment and related parts and supplies and are valued at the lower of cost or market on a weighted-average cost basis. As part of the valuation process, inventory reserves are established to state excess, slow-moving and damaged inventories at their estimated net realizable value. The valuation process for excess, slow-moving and damaged inventory contains uncertainty because management must use judgment to estimate when the inventory will be sold and the quantities and prices at which the inventory will be sold in the normal course of business. Inventory reserve policies are periodically reviewed, reflecting current risks, trends and changes in industry conditions. A reserve for estimated inventory shrinkage is also maintained and reflects the results of cycle count programs and physical inventories. When preparing these estimates, management considers historical results, inventory levels and current operating trends.

Inventory reserves of \$3.8 million and \$3.1 million at December 31, 2006 and 2005, respectively, have been established. The increase in inventory reserves is primarily due to the impact of higher amounts of excess and slow-moving inventory on hand at December 31, 2006 than at December 31, 2005, which is attributed to higher carrying values of inventory resulting from the transition into higher SEER and the introduction of new product lines. Inventory reserves are affected by a number of factors, including general economic conditions and other factors affecting demand as well as the effectiveness of the inventory management process for controlling inventory shrinkage. In the event the estimates differ from actual results, inventory-related reserves may be adjusted and could materially impact the consolidated results of operations.

Goodwill and Intangibles

The recoverability of goodwill and indefinite life intangibles is evaluated at least annually and when events or changes in circumstances indicate that the carrying amount of goodwill and indefinite life intangibles may not be recoverable. The identification and measurement of goodwill impairment involves the estimation of the fair value of reporting units and contains uncertainty because management must use judgment in determining appropriate assumptions to be used in the measurement of fair value. Indefinite life intangibles not subject to amortization are assessed for impairment by comparing the fair value of the intangible asset to its carrying amount to determine if a write-down to fair value is required. The estimates of fair value of the reporting units and indefinite life intangibles are based on the best information available as of the date of the assessment and incorporate management assumptions about expected future cash flows and contemplate other valuation techniques. Future cash flows can be affected by changes in industry or market conditions.

On January 1, 2007, the annual impairment tests were performed and it was determined there was no impairment. No factors have developed since the last impairment tests that would indicate that the carrying value of goodwill and indefinite life intangibles may not be recoverable. The carrying amount of goodwill and intangibles at December 31, 2006 was \$165.9 million. Although no impairment has been recorded to date, there can be no assurances that future impairments will not occur. An adjustment to the carrying value of goodwill and intangibles could materially impact the consolidated results of operations.

Self-Insurance Reserves

Self-insurance reserves are maintained relative to company-wide casualty insurance programs and for one subsidiary's health benefit program. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverages. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occurs and exceed these estimates, additional reserves may be required that could materially impact the consolidated results of operations. The estimation process contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. At December 31, 2006, a reserve of \$5.7 million was established related to such insurance programs versus \$5.2 million at December 31, 2005. The increase in the self-insurance reserves reflects the addition of the 2006 policy year.

Income Taxes

Income taxes are accounted for under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial reporting basis and the tax basis of assets and liabilities at enacted tax rates expected to be in effect when such amounts are recovered or settled. The use of estimates by management is required to determine income tax expense, deferred tax assets and any related valuation allowance and deferred tax liabilities. A valuation allowance of \$.4 million has been recorded at December 31, 2006 and 2005 due to uncertainties related to the ability to utilize a portion of the deferred tax assets primarily arising from state net operating loss carryforwards. The valuation allowance is based on estimates of future taxable income by jurisdiction in which the deferred tax assets will be recoverable. These estimates can be affected by a number of factors, including possible tax audits or general economic conditions or competitive pressures that could affect future taxable income. Although management believes that the estimates discussed above are reasonable, the deferred tax asset and any related valuation allowance will need to be adjusted if management's estimates of future taxable income differ from actual taxable income. An adjustment to the deferred tax asset and any related valuation allowance could materially impact the consolidated results of operations.

Results of Operations

The following table presents information derived from the consolidated statements of income expressed as a percentage of revenues for the years ended December 31, 2006, 2005 and 2004:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Revenues	100.0%	100.0%	100.0%
Cost of sales	74.3	74.9	74.4
Gross profit	25.7	25.1	25.6
Selling, general and administrative expenses	18.2	18.2	19.4
Operating income	7.5	6.9	6.2
Interest expense, net	.2	.2	.3
Income taxes	2.7	2.5	2.2
Net income	<u>4.6%</u>	<u>4.2%</u>	<u>3.7%</u>

The following narratives include the results of operations for businesses acquired during 2006, 2005 and 2004. The acquisitions were accounted for under the purchase method of accounting and, accordingly, their results of operations have been included in the consolidated results beginning on their respective dates of acquisition. In the following narratives, computations and disclosure information referring to "same-store basis" exclude the effects of locations acquired or locations opened or closed during the prior twelve months unless they are within close geographical proximity to existing locations.

Consolidated Comparison of Year Ended December 31, 2006 with Year Ended December 31, 2005

Revenues in 2006 increased \$118.0 million, or 7%, as compared to 2005, including a \$13.5 million contribution from locations acquired and opened during 2006 offset by \$2.3 million from closed locations. On a same-store basis, revenues increased \$106.8 million, or 6.4%, over 2005. The increase in same-store revenues reflects improving sales mix from the introduction of higher efficiency air conditioning systems, which sell at higher prices, and strong demand for commercial and refrigeration products.

Gross profit in 2006 increased \$39.9 million, or 9%, over 2005, primarily as a result of increased revenues. Gross profit margin increased 60 basis-points to 25.7% in 2006 from 25.1% in 2005. This increase reflects higher margins on recently introduced higher efficiency air conditioning systems as well as improved margins for non-equipment products.

Selling, general and administrative expenses as a percent of revenues remained consistent at 18.2% in both 2006 and 2005. Selling, general and administrative expenses in 2006 increased \$20.7 million, or 7%, over 2005. On a same-store basis, selling, general and administrative expenses were up 6% compared to 2005 primarily due to increases in certain variable expenses related to our increased revenues and gross profit, higher share-based compensation and increase in the provision for doubtful accounts.

Net interest expense in 2006 increased \$.5 million, or 14%, compared to 2005, primarily due to higher outstanding borrowings.

The effective tax rate was 37.5% in 2006 and 38.1% in 2005. The decrease in the effective tax rate in 2006 is due to the realization of employment tax credits and various other initiatives.

Net income for 2006 increased \$12.3 million, or 18%, compared to 2005. The increase in net income was primarily driven by the higher revenues and expansion of gross profit margin discussed above.

Consolidated Comparison of Year Ended December 31, 2005 with Year Ended December 31, 2004

Revenues in 2005 increased \$367.7 million, or 28%, as compared to 2004, including a \$227.0 million contribution from locations acquired and opened during 2005 offset by \$1.7 million from closed locations. On a same-store basis, revenues increased \$142.4 million, or 11%, over 2004, reflecting strong market conditions for the replacement of residential and light-commercial HVAC products.

Gross profit in 2005 increased \$86.1 million, or 26%, over 2004, primarily as a result of increased revenues. Gross profit margin decreased 50 basis-points to 25.1% in 2005 from 25.6% in 2004. The decrease primarily results from the addition of East Coast Metal Distributors, Inc. ("East Coast"), which historically had lower gross profit margins than our consolidated margins, as well as a proportionately higher sales mix of HVAC equipment versus parts and supplies. On a same-store basis, gross profit increased \$34.8 million, or 10%, over 2004.

Selling, general and administrative expenses as a percent of revenues decreased to 18.2% in 2005 from 19.4% in 2004, from leveraging of fixed operating costs. Selling, general and administrative expenses in 2005 increased \$51.7 million, or 20%, over 2004, primarily due to the addition of East Coast. On a same-store basis, selling, general and administrative expenses were up 6% compared to 2004 primarily due to increases in certain variable expense items from higher revenues.

Net interest expense in 2005 decreased \$1.1 million, or 24%, compared to 2004, primarily due to lower outstanding borrowings and higher interest income.

The effective tax rate was 38.1% in 2005 and 38.0% in 2004. The increase in the effective tax rate in 2005 primarily relates to higher state income tax expense.

Net income for 2005 increased \$21.9 million, or 46%, compared to 2004. The increase in net income was primarily driven by the higher revenues as well as by the lower levels of selling, general and administrative expenses as a percent of revenues and decreased net interest expense discussed above.

Liquidity and Capital Resources

We assess liquidity in terms of our ability to generate cash to execute our business strategy and fund operating and investing activities and take into consideration the seasonal demand of HVAC products, which peak in the months of May through August. Significant factors affecting liquidity include cash flows generated from operating activities, the adequacy of available bank lines of credit and the ability to attract long-term capital with satisfactory terms, capital expenditures, acquisitions, the timing and extent of common stock repurchases and dividend policy.

We maintain a bank-syndicated, unsecured revolving credit agreement that provides for borrowings of up to \$100.0 million, expiring in December 2009. Borrowings are used to fund seasonal working capital needs and for other general corporate purposes, including acquisitions and issuance of letters of credit. Borrowings bear interest at primarily LIBOR-based rates plus a spread that is dependent upon Watsco's financial performance (LIBOR plus .475% and .625% at December 31, 2006 and 2005, respectively). A variable commitment fee is paid on the unused portion of the credit line (.125% and .15% at December 31, 2006 and 2005, respectively). At December 31, 2006 and 2005, \$30.0 million was outstanding under the revolving credit agreement.

A \$125.0 million unsecured private placement shelf facility is also maintained as a source of borrowings. The uncommitted shelf facility provides fixed-rate financing through December 2007 as a complement to the variable rate borrowings available under the revolving credit agreement. \$10.0 million and \$20.0 million, respectively, of Senior Series A Notes ("Notes") were outstanding at December 31, 2006 and 2005, under the facility bearing interest at 7.07%. The Notes will be repaid on April 9, 2007. Accordingly, \$10.0 million is classified as "current" in the consolidated balance sheet at December 31, 2006. Interest is paid on a quarterly basis. The Notes may be redeemed prior to maturity subject to a redemption premium and other restrictions.

Both the revolving credit agreement and the private placement shelf facility contain customary affirmative and negative covenants including certain financial covenants with respect to consolidated leverage, interest and debt coverage ratios and limits capital expenditures, dividends and share repurchases in addition to other restrictions. We believe that we are in compliance with all covenants and financial ratios at December 31, 2006.

At December 31, 2006 and 2005, one interest rate swap agreement was in effect with a notional value of \$30.0 million to manage the net exposure to interest rate changes related to \$30.0 million of borrowings under the revolving credit agreement. The interest rate swap agreement, which expires in October 2007, effectively converts the LIBOR-based variable rate borrowings into fixed rate borrowings. Developments in the capital markets are continuously monitored and swap transactions are entered into solely with established counterparties having investment grade ratings. See Note 10 to the consolidated financial statements and “Quantitative and Qualitative Disclosures about Market Risk,” for further information.

Working capital increased to \$361.6 million at December 31, 2006 from \$314.7 million at December 31, 2005, primarily due to increased inventory levels and lower accrued expenses. Working capital was also impacted by a higher cash balance at December 31, 2006 compared to December 31, 2005. The increase in working capital was primarily funded by operating cash flows.

Net cash provided by operating activities was \$68.5 million in 2006 compared to \$35.8 million in 2005. The 2005 operating cash flows were heavily impacted by the buildup of inventory in anticipation of the transition into the higher efficiency units and higher accounts receivable driven by increased sales volume. Operating cash flows for 2006 were also benefited from higher net income, offset by the classification of \$8.4 million in excess tax benefits from share-based compensation as a financing cash inflow rather than an operating cash inflow as a result of adopting Statement of Financial Accounting Standards (“SFAS”) No. 123R on January 1, 2006. See Note 1 to the consolidated financial statements for further information on the impact of SFAS No. 123R to our consolidated statements of cash flows.

Net cash used in investing activities decreased to \$22.3 million in 2006 from \$54.7 million in 2005, primarily due to an acquisition in 2005.

In the fourth quarter of 2006, one of our subsidiaries completed two acquisitions. A&R Supply, Inc., a distributor of refrigeration products founded in 1957 and headquartered in Memphis, Tennessee, was acquired in October 2006, adding eight new locations to the western Tennessee, Mississippi and Arkansas markets. ASHA Distributing, Inc., a distributor of air conditioning and heating products founded in 1982 and headquartered in Omaha, Nebraska, was acquired in December 2006, adding 10 locations to the Nebraska, Missouri and Kansas markets.

In the first quarter of 2006, one of our subsidiaries completed the acquisition of a refrigeration equipment distributor with locations in Birmingham and Montgomery, Alabama. Also in the first quarter of 2006, another subsidiary completed the purchase of the net assets and business of a wholesale distributor of air conditioning and heating products operating from a single location in Kansas City, Missouri.

In January 2005, we acquired East Coast one of the nation’s largest distributors of air conditioning and heating products, with 27 locations in North Carolina, South Carolina, Georgia, Virginia and Tennessee for cash consideration of \$49.5 million.

The results of operations of acquired locations have been included in the consolidated financial statements from their respective dates of acquisition. The proforma effect of these acquisitions was not deemed material to the consolidated financial statements for the years ended December 31, 2006, 2005 and 2004.

Net cash used in financing activities of \$39.6 million in 2006 was primarily used for the payment of cash dividends, stock repurchases and a \$10.0 million repayment of long-term notes, partially offset by \$8.4 million in excess tax benefits from share-based compensation classified as a financing cash inflow that would have been classified as an operating cash inflow had we not adopted SFAS No. 123R and proceeds received from the exercise of stock options and from purchases under an employee stock purchase plan.

Watsco’s Board of Directors in 1999 authorized the repurchase, at management’s discretion, of 7.5 million shares of common stock in the open market or via private transactions. Shares repurchased under the program are accounted for using the cost method and result in a reduction of shareholders’ equity. Repurchases totaled 243,600 shares at a cost of \$15.3 million in 2006, 347,600 shares at a cost of \$17.7 million in 2005 and 29,900 shares at a cost of \$.8 million in 2004. In aggregate, 6.0 million shares of Common stock and Class B common stock have been repurchased at a cost of \$100.2 million since the inception of the program. The remaining 1.5 million shares authorized for repurchase are subject to certain restrictions included in the debt agreements.

Cash dividends of 95 cents, 62 cents and 38 cents per share of Common stock and Class B common stock were paid in 2006, 2005 and 2004, respectively. In April 2006, Watsco’s Board of Directors approved an increase in the quarterly cash dividend to 25 cents

per share from 20 cents per share of Common and Class B common stock. In February 2007, Watsco's Board of Directors approved an increase in the quarterly cash dividend to 33 cents per share from 25 cents per share. Future dividends and/or dividend rate increases will be at the sole discretion of the Board of Directors and will depend upon such factors as profitability, financial condition, cash requirements, restrictions under debt agreements, future prospects and other factors deemed relevant by Watsco's Board of Directors.

We believe there is adequate availability of capital from operations and current credit facilities to fund working capital requirements and support the development of our short-term and long-term operating strategies. As of December 31, 2006, we had \$34.3 million of cash and cash equivalents, \$65.4 million of additional borrowing capacity under the revolving credit agreement and \$115.0 million available under the private placement shelf facility (subject to certain borrowing limitations) to fund present operations and anticipated growth, including expansion in our current and targeted market areas. Potential acquisitions are continually evaluated and discussions are conducted with a number of acquisition candidates. Should suitable acquisition opportunities or working capital needs arise that would require additional financing, we believe that our financial position and earnings history provide a sufficient base for obtaining additional financing resources at competitive rates and terms or gives us the ability to raise funds through the issuance of equity securities if required.

Recent Events

Contractual Obligations and Off-Balance Sheet Arrangements

The following table summarizes our significant contractual obligations as of December 31, 2006 (in millions):

Contractual Obligations	Payments due by Period						Total
	2007	2008	2009	2010	2011	Thereafter	
Non-cancelable operating lease obligations	\$39.2	\$32.5	\$25.0	\$17.2	\$10.9	\$ 17.7	\$142.5
Long-term debt	10.0	—	—	—	—	—	10.0
Minimum royalty payments	1.0	1.0	1.0	1.0	1.0	—	5.0
Other debt	0.1	0.1	—	—	—	—	0.2
Total Contractual Obligations	\$50.3	\$33.6	\$26.0	\$18.2	\$11.9	\$ 17.7	\$157.7

Commercial obligations outstanding at December 31, 2006 under the revolving credit agreement consist of borrowings totaling \$30.0 million, standby letters of credit totaling \$4.1 million and commercial letters of credit totaling \$5 million. Borrowings under the revolving credit agreement at December 31, 2006 had revolving maturities of 90 days and letters of credit have varying terms expiring through January 2008.

Standby letters of credit are primarily used as collateral under self-insurance programs and are not expected to result in any material losses or obligation as the obligations under the programs will be met in the ordinary course of business. Accordingly, the estimated fair value of these instruments is zero at December 31, 2006. See Note 10 to the consolidated financial statements for further information.

Quantitative and Qualitative Disclosures about Market Risk

The primary market risk exposure for Watsco is interest rate risk. The objective in managing the exposure to interest rate changes is to limit the impact of interest rate changes on earnings and cash flows and to lower our overall borrowing costs. To achieve this objective, interest rate swaps are used to manage net exposure to interest rate changes to our borrowings. These swaps are entered into with financial institutions with investment grade credit ratings, thereby minimizing the risk of credit loss. All items described are non-trading. See Notes 1 and 10 to the consolidated financial statements for further information.

Interest rate swap agreements reduce the exposure to market risks from changing interest rates under the revolving credit agreements. Under the swap agreements, Watsco agrees to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to a notional principal amount. Any differences paid or received on interest rate swap agreements are recognized as adjustments to interest expense over the life of each swap, thereby adjusting the effective interest rate on the underlying obligation. Financial instruments are not held for trading purposes. Derivatives used for hedging purposes must be designated as, and effective as, a hedge of the identified risk exposure at the inception of the contract. Accordingly, changes in the fair value of the derivative contract must be highly correlated with changes in the fair value of the underlying hedged item at inception of the hedge and over the life of the hedge contract.

Swap agreements are accounted for based on the guidance of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Under SFAS No. 133, all derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive loss ("OCL") and are recognized in the income statement when the hedged items affect earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

At December 31, 2006 and 2005, one interest rate swap agreement was in effect with a notional value of \$30.0 million maturing in 2007, exchanging the variable rate of 90-day LIBOR to fixed interest rate payments of 6.25%. The interest rate swap was effective as a cash flow hedge and no charge to earnings was required in 2006, 2005 or 2004 for hedge ineffectiveness. The negative fair value of the derivative financial instrument was \$.3 million and \$.9 million at December 31, 2006 and 2005, respectively, and is included, net of accrued interest, in deferred income taxes and other liabilities in the consolidated balance sheets.

At December 31, 2006, 2005 and 2004, \$.1 million, net of deferred tax benefits of \$.08 million, \$.5 million net of deferred tax benefits of \$.3 million and \$1.3 million net of deferred tax benefits of \$.8 million was recorded in OCL associated with cash flow hedge. During 2006, 2005 and 2004, we recognized decreases in unrealized losses in OCL relating to cash flow hedges of \$.3 million, net of income tax expense of \$.2 million, \$.9 million, net of income tax expense of \$.5 million and \$.8 million, net of income tax expense of \$.4 million, respectively.

The change in OCL during 2006, 2005 and 2004, reflected the reclassification of \$.2 million, net of income tax benefit of \$.1 million, \$.6 million, net of income tax benefit of \$.3 million and \$.9 million, net of income tax benefit of \$.6 million, respectively, of losses from accumulated OCL to current period earnings (recorded in interest expense, net in the consolidated statements of income). The net deferred loss recorded in accumulated OCL will be reclassified to earnings on a quarterly basis as interest payments occur. As of December 31, 2006, approximately \$.3 million in deferred losses on the derivative instrument accumulated in OCL is expected to be reclassified to earnings during the next twelve months using a current three month LIBOR-based average receive rate (5.17% at December 31, 2006).

At December 31, 2006 and 2005, Watsco's exposure to interest rate changes was limited to variable rate lease payments which are indexed to one month LIBOR. To assess our exposure to changes in interest rates, we performed a sensitivity analysis to determine the impact to earnings associated with an immediate 100 basis point fluctuation from one month LIBOR. Based on the results of this simulation, as of December 31, 2006 and 2005, net income would decrease or increase by approximately \$.1 million on an annual basis if there were an immediate 100 basis point increase or decrease, respectively, in one month LIBOR. This information constitutes a "forward-looking statement" and actual results may differ significantly based on actual borrowings and interest rates.

Recently Issued Accounting Standards

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of SFAS No. 157 are effective for us beginning January 1, 2008. We are currently evaluating the impact of adopting SFAS No. 157 on our consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." SAB No. 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB No. 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. SAB No. 108 permits existing public companies to initially apply its provisions either by (i) restating prior financial statements as if the "dual approach" had always been used or (ii) recording the cumulative effect of initially applying the "dual approach" as adjustments to the carrying value of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of the "cumulative effect" transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. The adoption of SAB No. 108 did not have a material impact on our consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" ("FIN No. 48"). This interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." This interpretation seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, it requires expanded disclosure with respect to the uncertainty in income taxes. FIN No. 48 is effective January 1, 2007 and is not expected to have a material impact on our consolidated financial statements.

Information about Forward-Looking Statements

This Annual Report contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) business and acquisition strategies, (ii) potential acquisitions, (iii) financing plans and (iv) industry, demographic and other trends affecting Watsco's financial condition or results of operations. These forward-looking statements are based largely on management's current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including

- general economic conditions affecting general business spending,
- consumer spending,
- consumer debt levels,
- seasonal nature of product sales,
- weather conditions,
- effects of supplier concentration,
- competitive factors within the HVAC industry,
- insurance coverage risks,
- prevailing interest rates, and
- the continued viability of Watsco's business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if substantially realized, that the information will have the expected consequences to or effects on Watsco or its business or operations. A discussion of certain of these risks and uncertainties that could cause actual results to differ materially from those predicted in such forward-looking statements is included in Watsco's Annual Report to Shareholders for the fiscal year ended December 31, 2006 in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations," which section has been incorporated in the Form 10-K by reference. Forward-looking statements speak only as of the date the statement was made. Watsco assumes no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information.

Corporate Governance

On June 13, 2006, Watsco submitted to the New York Stock Exchange ("NYSE") the annual Chief Executive Officer Certification required under Section 303A 12(a) of the NYSE Listed Company Manual. In addition, Watsco filed with the Securities and Exchange Commission the certifications required under Section 302 of the Sarbanes-Oxley Act of 2002 as Exhibits 31.1, 31.2 and 31.3 to its Annual Report on Form 10-K for the year ended December 31, 2006.

WATSCO, INC. AND SUBSIDIARIES
MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Watsco's internal control system was designed to provide reasonable assurance to our management and Board of Directors regarding the reliability of financial reporting and the preparation and fair presentation of our published consolidated financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our Chief Executive Officer, Senior Vice President and Chief Financial Officer, we conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006. The assessment was based on criteria established in the framework *Internal Control — Integrated Framework*, issued by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission. Based on this assessment under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2006. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by Grant Thornton LLP, an independent registered public accounting firm, as stated in their report that is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON THE FINANCIAL STATEMENTS

The Board of Directors and Shareholders of
Watsco, Inc.

We have audited the accompanying consolidated balance sheets of Watsco, Inc. (a Florida Corporation) and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity and cash flows for each of the two years then ended. These 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 auditing 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Watsco, Inc. and subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the two years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 1 and 6 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standard 123 (R) "Share-Based Payment" on a prospective basis on January 1, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Watsco, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission and our report dated March 1, 2007 expressed an unqualified opinion on both management's assessment of Watsco, Inc.'s internal control over financial reporting and on the effectiveness of Watsco, Inc.'s internal control over financial reporting.

/s/ GRANT THORNTON LLP

Miami, Florida
March 1, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON THE FINANCIAL STATEMENTS

The Board of Directors and Shareholders of
Watsco, Inc.

We have audited the accompanying consolidated statements of income, shareholders' equity and cash flows of Watsco, Inc. and subsidiaries for the year ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of Watsco, Inc. and subsidiaries for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

/s/ ERNST & YOUNG LLP
Certified Public Accountants

Miami, Florida
March 14, 2005

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Board of Directors and Shareholders of
Watsco, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Watsco, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Watsco, Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Watsco, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Watsco, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Watsco, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the two years then ended and our report dated March 1, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ GRANT THORNTON LLP

Miami, Florida
March 1, 2007

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

<i>(In thousands, except per share data)</i>	Years Ended December 31,		
	2006	2005	2004
Revenues	\$ 1,800,759	\$ 1,682,724	\$ 1,315,024
Cost of sales	1,337,859	1,259,694	978,089
Gross profit	462,900	423,030	336,935
Selling, general and administrative expenses	327,297	306,572	254,883
Operating income	135,603	116,458	82,052
Interest expense, net	3,820	3,342	4,413
Income before income taxes	131,783	113,116	77,639
Income taxes	49,419	43,097	29,534
Net income	<u>\$ 82,364</u>	<u>\$ 70,019</u>	<u>\$ 48,105</u>
Earnings per share for Common and Class B common stock:			
Basic	\$ 3.15	\$ 2.69	\$ 1.89
Diluted	<u>\$ 2.96</u>	<u>\$ 2.52</u>	<u>\$ 1.79</u>
Weighted average Common and Class B common shares and equivalent shares used to calculate earnings per share:			
Basic	26,150	26,049	25,507
Diluted	<u>27,829</u>	<u>27,769</u>	<u>26,931</u>

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

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

<i>(In thousands, except share and per share data)</i>	December 31,	
	2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 34,340	\$ 27,650
Accounts receivable, net	180,968	191,747
Inventories	291,024	266,543
Other current assets	11,476	8,051
Total current assets	<u>517,808</u>	<u>493,991</u>
Property and equipment, net	21,476	17,244
Goodwill	161,107	158,912
Other assets	10,980	8,584
	<u>\$ 711,371</u>	<u>\$ 678,731</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term obligations	\$ 10,084	\$ 10,079
Accounts payable	103,210	100,829
Accrued expenses and other current liabilities	42,897	68,390
Total current liabilities	<u>156,191</u>	<u>179,298</u>
Long-term obligations:		
Borrowings under revolving credit agreement	30,000	30,000
Long-term notes, net of current portion	—	10,000
Other long-term obligations, net of current portion	118	189
Total long-term obligations	<u>30,118</u>	<u>40,189</u>
Deferred income taxes and other liabilities	8,676	8,594
Commitments and contingencies (Notes 10 and 11)		
Shareholders' equity:		
Common stock, \$0.50 par value, 60,000,000 shares authorized in 2006 and 2005 and 30,116,262 and 29,860,948 shares issued in 2006 and 2005, respectively	15,059	14,931
Class B common stock, \$0.50 par value, 10,000,000 shares authorized in 2006 and 2005 and 3,750,782 and 3,392,497 shares issued in 2006 and 2005, respectively	1,875	1,696
Paid-in capital	253,422	264,903
Deferred compensation on non-vested stock	—	(35,894)
Accumulated other comprehensive loss, net of tax	(126)	(478)
Retained earnings	346,375	290,383
Treasury stock, at cost, 6,034,213 and 5,790,613 shares of Common and Class B common stock in 2006 and 2005, respectively	(100,219)	(84,891)
Total shareholders' equity	<u>516,386</u>	<u>450,650</u>
	<u>\$ 711,371</u>	<u>\$ 678,731</u>

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

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

<i>(In thousands, except share and per share data)</i>	Common Stock and Class B Common Stock Shares	Amount	Paid-In Capital	Deferred Compensation on Non-Vested Stock	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2003	26,323,697	\$15,869	\$226,363	\$ (12,294)	\$ (2,075)	\$199,340	\$ (66,334)	\$360,869
Net income						48,105		48,105
Changes in unrealized gains and losses on available-for-sale securities and a derivative instrument, net of income taxes					807			807
Comprehensive income								48,912
Retirement of common stock	(11,181)	(6)	(326)					(332)
Common stock contribution to 401(k) plan	62		1					1
Stock issuances from exercise of stock options and employee stock purchase plan	502,775	252	6,596					6,848
Tax benefit from stock-based compensation			2,746					2,746
Issuances of non-vested shares of common stock	150,000	75	4,214	(4,289)				—
Forfeitures of non-vested shares of common stock	(80,000)	(40)	(967)	1,007				—
Non-vested shares of common stock to be issued				(6,369)				(6,369)
Amortization of unearned compensation				1,002				1,002
Cash dividends declared on Common and Class B common stock, \$0.38 per share						(10,103)		(10,103)
Purchase of treasury stock	(29,900)						(836)	(836)
Balance at December 31, 2004	26,855,453	16,150	238,627	(20,943)	(1,268)	237,342	(67,170)	402,738
Net income						70,019		70,019
Changes in unrealized gains and losses on available-for-sale securities and a derivative instrument, net of income taxes					790			790
Comprehensive income								70,809
Retirement of common stock	(115,614)	(58)	(5,754)					(5,812)
Common stock contribution to 401(k) plan	25,579	13	888					901
Stock issuances from exercise of stock options and employee stock purchase plan	589,926	294	7,747					8,041
Tax benefit from stock-based compensation			7,654					7,654
Issuances of non-vested shares of common stock	314,552	157	11,377	(5,165)				6,369
Forfeitures of non-vested shares of common stock	(5,000)	(2)	(63)	65				—
Common stock issued for acquisition	145,536	73	4,427					4,500
Non-vested shares of common stock to be issued				(12,379)				(12,379)
Amortization of unearned compensation				2,528				2,528
Cash dividends declared on Common and Class B common stock, \$0.62 per share						(16,978)		(16,978)
Purchase of treasury stock	(347,600)						(17,721)	(17,721)
Balance at December 31, 2005	27,462,832	16,627	264,903	(35,894)	(478)	290,383	(84,891)	450,650
Net income						82,364		82,364
Changes in unrealized gains and losses on available-for-sale securities and a derivative instrument, net of income taxes					352			352
Comprehensive income								82,716
Retirement of common stock	(150,086)	(75)	(10,488)					(10,563)
Common stock contribution to 401(k) plan	19,055	10	1,130					1,140
Stock issuances from exercise of stock options and employee stock purchase plan	460,144	230	8,143					8,373
Excess tax benefit from stock-based compensation			8,371					8,371
Issuances of non-vested shares of common stock	287,359	144	12,235					12,379
Forfeitures of non-vested shares of common stock	(2,873)	(2)	2					—
Share-based compensation			5,020					5,020
Adoption of SFAS No. 123R, "Share-Based Payment"			(35,894)	35,894				—
Cash dividends declared on Common and Class B common stock, \$0.95 per share						(26,372)		(26,372)
Purchase of treasury stock	(243,600)						(15,328)	(15,328)
Balance at December 31, 2006	27,832,831	\$16,934	\$253,422	—	\$ (126)	\$346,375	\$(100,219)	\$516,386

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

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>(In thousands)</i>	Years Ended December 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net income	\$ 82,364	\$ 70,019	\$ 48,105
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,908	6,189	6,768
Share-based compensation	5,020	2,528	1,002
Provision for doubtful accounts	3,461	1,854	1,556
(Gain) loss on sale of property and equipment	(199)	(1,460)	214
Net gain on sale of available-for-sale securities	—	(106)	—
Deferred income tax provision	(535)	197	3,883
Non-cash contribution for 401(k) plan	1,140	1,181	922
Excess tax benefits from share-based compensation	(8,371)	—	—
Tax benefits from share-based compensation	—	7,654	2,746
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	9,716	(26,000)	(7,855)
Inventories	(18,026)	(33,271)	(23,412)
Accounts payable and other liabilities	(10,036)	4,716	19,579
Other, net	(1,901)	2,281	3,231
Net cash provided by operating activities	<u>68,541</u>	<u>35,782</u>	<u>56,739</u>
Cash flows from investing activities:			
Capital expenditures	(9,992)	(7,283)	(4,846)
Business acquisitions, net of cash acquired	(9,889)	(49,481)	(3,403)
Purchases of marketable securities	(2,847)	—	—
Proceeds from sale of available-for-sale securities	—	160	—
Proceeds from sale of property and equipment	448	1,876	4,946
Net cash used in investing activities	<u>(22,280)</u>	<u>(54,728)</u>	<u>(3,303)</u>
Cash flows from financing activities:			
Common and Class B common stock dividends	(26,372)	(16,978)	(10,103)
Purchase of treasury stock	(15,328)	(17,721)	(836)
Repayment of long-term notes	(10,000)	(10,000)	—
Net proceeds from (repayments of) other long-term obligations	(64)	57	(114)
Repayment under revolving credit agreement	—	—	(30,000)
Proceeds from revolving credit agreement	—	—	30,000
Payment of debt acquisition costs	—	—	(346)
Net proceeds from issuances of common stock	3,822	6,094	6,768
Excess tax benefits from share-based compensation	8,371	—	—
Net cash used in financing activities	<u>(39,571)</u>	<u>(38,548)</u>	<u>(4,631)</u>
Net increase (decrease) in cash and cash equivalents	6,690	(57,494)	48,805
Cash and cash equivalents at beginning of year	27,650	85,144	36,339
Cash and cash equivalents at end of year	<u>\$ 34,340</u>	<u>\$ 27,650</u>	<u>\$ 85,144</u>

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

WATSCO, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share data)

1. Summary of Significant Accounting Policies

Nature of Operations

Watsco, Inc. and its subsidiaries (collectively, "Watsco", which may be referred to as *we*, *us* or *our*) is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies ("HVAC") in the United States. We operate from 380 locations in 32 states at December 31, 2006.

Basis of Consolidation

The consolidated financial statements include the accounts of Watsco and all of its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include valuation reserves for accounts receivable, inventory and income taxes, reserves related to self-insurance programs and valuation of goodwill. Actual results could differ from those estimates.

Accounting Change

At December 31, 2006, we had two share-based compensation plans for employees, which are described more fully in Note 6. Prior to January 1, 2006, we accounted for those plans in accordance with the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations, as permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." Prior to January 1, 2006, share-based compensation was recognized only for grants of non-vested (restricted) stock and share-based compensation expense was not recognized for stock options. Effective January 1, 2006, we adopted the provisions of SFAS No. 123R, "Share-Based Payment," using the modified prospective transition method. Under this transition method, compensation expense recognized during the year ended December 31, 2006 included: (a) compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 and (b) compensation expense for all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated.

The impact of adopting SFAS No. 123R on January 1, 2006 was a reduction of our income before income taxes and net income of \$1,451 and \$906, respectively, for the year ended December 31, 2006. Also, basic and diluted earnings per share were reduced by \$.03 for the year ended December 31, 2006, as a result of adopting SFAS No. 123R.

Prior to the adoption of SFAS No. 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the consolidated statements of cash flows. SFAS No. 123R requires the cash flows from the tax benefits resulting from tax deductions in excess of the compensation expense recognized for those options (excess tax benefits) to be classified as financing cash flows. The excess tax benefits of \$8,371 classified as a financing cash inflow would have been classified as an operating cash inflow if we had not adopted SFAS No. 123R.

Prior to the adoption of SFAS No. 123R, the intrinsic value of our non-vested stock was recorded as deferred compensation as of December 31, 2005. Upon the adoption of SFAS No. 123R on January 1, 2006, the deferred compensation balance of \$35,894 was reclassified to paid-in capital.

In accordance with the modified prospective transition method, results for the years ended December 31, 2005 and 2004 have not been restated. Had compensation cost been determined based on the fair value method at the grant dates for awards under the stock-based compensation plans consistent with the method of SFAS No. 123, pro forma net income and earnings per share would be as follows:

<u>Years Ended December 31,</u>	<u>2005</u>	<u>2004</u>
Net income, as reported	\$70,019	\$48,105
Stock-based compensation expense included in net income, net of tax	1,567	621
Stock-based compensation expense determined under the fair value-based method, net of tax	(3,247)	(2,258)
Net income, pro forma	<u>\$68,339</u>	<u>\$46,468</u>
Basic earnings per share for Common and Class B common stock:		
As reported	\$ 2.69	\$ 1.89
Pro forma	\$ 2.62	\$ 1.82
Diluted earnings per share for Common and Class B common stock:		
As reported	\$ 2.52	\$ 1.79
Pro forma	\$ 2.46	\$ 1.73

Cash Equivalents

All highly liquid instruments purchased with an original maturity of three months or less are considered to be cash equivalents. Cash equivalents at December 31, 2006 and 2005 included \$9,825 and \$45, respectively, of municipal securities with put options of 7 days or less, which were considered to be cash equivalents for purposes of the consolidated financial statements. No individual municipal security equaled or exceeded 2% of total assets and such securities were investment grade and collateralized by a letter of credit issued by the remarketing agent.

Accounts Receivable Allowance

An allowance for doubtful accounts is maintained for estimated losses resulting from the inability of customers to make required payments. When preparing these estimates, Watsco's management considers a number of factors, including the aging of a customer's account, past transactions with customers, creditworthiness of specific customers, historical trends and other information. We typically do not require our customers to provide collateral. Accounts receivable reserve policies are reviewed periodically, reflecting current risks, trends and changes in industry conditions. The past due status of an account is determined based on stated payment terms. Upon determination that an account is uncollectible, Watsco writes off the receivable balance. At December 31, 2006 and 2005, the allowance for doubtful accounts totaled \$3,140 and \$3,019, respectively. Although we believe the allowance is sufficient, if the financial condition of our customers were to unexpectedly deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventories

Inventories consist of air conditioning, heating and refrigeration equipment and related parts and supplies and are valued at the lower of cost or market on a weighted-average cost basis. As part of the valuation process, inventory reserves are established to state excess and slow-moving inventories at their estimated net realizable value. Inventory reserve policies are reviewed periodically, reflecting current risks, trends and changes in industry conditions. A reserve for estimated inventory shrinkage is also maintained to consider inventory shortages determined from cycle counts and physical inventories. At December 31, 2006 and 2005, inventory reserves totaled \$3,792 and \$3,142, respectively.

Vendor Rebates

We account for vendor rebates in accordance with Emerging Issues Task Force ("EITF") Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." We have arrangements with several vendors that provide rebates payable to us when we achieve any of a number of measures, generally related to the volume level of purchases. We account for such rebates as a reduction of inventory until we sell the product, at which time such rebates are reflected as a reduction of cost of sales in our consolidated statements of income. Throughout the year, we estimate the amount of the rebate based on our estimate of purchases to date relative to the purchase levels that mark our progress toward earning the rebates. We continually revise these estimates of earned vendor rebates based on actual purchase levels. At December 31, 2006 and 2005, we have \$4,905 and \$4,866, respectively, of rebates recorded as a reduction of inventory. Substantially all vendor rebate receivables are collected within three months immediately following the end of the year.

Marketable Securities

Investments in marketable equity securities of \$2,863 at December 31, 2006 are included in other assets and are classified as available-for-sale. These securities are recorded at fair value with unrealized holding gains and losses, net of deferred taxes, reported in accumulated other comprehensive loss ("OCL") within shareholders' equity. Dividend and interest income are recognized in the statement of income when earned. At December 31, 2006, \$10 of unrealized gains, net of deferred taxes of \$6, was included in accumulated OCL. At December 31, 2005, we held no marketable equity securities. Net realized gains amounted to \$106 for the year ended December 31, 2005.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of property and equipment is computed using the straight-line method. Buildings and improvements are being depreciated or amortized over estimated useful lives ranging from 3-40 years. Leasehold improvements are amortized over the shorter of the respective lease terms or estimated useful lives. Estimated useful lives for other depreciable assets range from 3-10 years. Depreciation and amortization expense related to property and equipment amounted to \$5,846, \$6,064 and \$6,765 for the years ended December 31, 2006, 2005 and 2004, respectively.

Goodwill and Intangibles

Goodwill is recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," an annual impairment review is performed, or more frequently if indicators of potential impairment exist, to determine if the carrying value of the recorded goodwill is impaired. The impairment review process compares the fair value of the reporting unit in which goodwill resides to its carrying value. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the implied fair value of goodwill (as defined under SFAS No. 142) within the reporting unit is less than its carrying value (see Note 8).

Intangible assets primarily consist of the value of trade names, non-compete agreements and customer relationships. Indefinite life intangibles not subject to amortization are assessed for impairment at least annually, or more frequently if events or changes in circumstances indicate they may be impaired, by comparing the fair value of the intangible asset to its carrying amount to determine if a write-down to fair value is required. Intangible assets with finite lives are amortized using the straight-line method over their respective estimated useful lives, which range from seven to ten years. Amortization expense related to intangible assets amounted to \$62, \$125 and \$3 for the years ended December 31, 2006, 2005 and 2004, respectively. Based on the current amount of finite lived intangible assets, we estimate amortization expense to be approximately \$60 for each of the next five years (see Note 8).

Recoverability of Long-Lived Assets

The recoverability of long-lived assets is evaluated when events or changes in circumstances indicate that the carrying amount of long-lived assets may not be recoverable. When events or changes in circumstances indicate that the carrying amount of long-lived assets may not be recoverable, a determination is made whether the amortization of the balance over its remaining life can be recovered through undiscounted future operating cash flows. The amount of impairment, if any, is measured based on projected discounted cash flows using a discount rate reflecting the average cost of funds and compared to the asset's carrying value. As of December 31, 2006, there were no such events or circumstances.

Revenue Recognition

Revenue is recognized in accordance with Securities and Exchange Commission Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition" (which superceded SAB No. 101, "Revenue Recognition in Financial Statements," as amended by SAB 101A and 101B). Revenue primarily consists of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the amounts recognized are fixed and determinable, and (4) collectibility is reasonably assured. Revenue is recorded when shipment of products or delivery of services has occurred. Assessment of collection is based on a number of factors, including past transactions, credit-worthiness of customers, historical trends and other information. Substantially all customer returns relate to products that are returned under warranty obligations underwritten by manufacturers, effectively mitigating the risk of loss for customer returns.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense amounted to \$6,210, \$5,975 and \$4,477 for the years ended December 31, 2006, 2005 and 2004, respectively.

Shipping and Handling

Shipping and handling costs associated with inbound freight are capitalized to inventories and relieved through cost of sales as inventories are sold. Shipping and handling costs associated with the delivery of products is included in selling, general and administrative expenses. Shipping and handling costs included in selling, general and administrative expenses amounted to \$6,914, \$6,827 and \$5,553 for the years ended December 31, 2006, 2005 and 2004, respectively.

Income Taxes

We record federal and state income taxes currently payable, as well as deferred taxes due to temporary differences between reporting income and expenses for financial statement purposes versus tax purposes. Deferred tax assets and liabilities reflect the temporary differences between the financial statement and income tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized as income or expense in the period that includes the

enactment date. Watsco and its eligible subsidiaries file a consolidated United States federal income tax return. As income tax returns are generally not filed until well after the closing process for the December 31 financial statements is complete, the amounts recorded at December 31 reflect estimates of what the final amounts will be when the actual income tax returns are filed for that calendar year. In addition, estimates are often required with respect to, among other things, the appropriate state income tax rates to use in the various states that Watsco and its subsidiaries are required to file, the potential utilization of operating loss carry-forwards and valuation allowances required, if any, for tax assets that may not be realizable in the future.

Earnings per Share

We calculate earnings per share using the two-class method in accordance with SFAS No. 128, "Earnings Per Share," as clarified by EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings Per Share." EITF Issue No. 03-6 requires the income per share for each class of common stock to be calculated assuming 100% of our earnings are distributed as dividends to each class of common stock based on their respective dividend rights, even though we do not anticipate distributing 100% of our earnings as dividends. The effective result of EITF Issue No. 03-6 is that the calculation of earnings per share for each class of our common stock yields the same basic and diluted earnings per share.

Basic earnings per share for our Common and Class B common stock is computed by dividing net income allocated to Common stock and Class B common stock by the weighted-average number of shares of Common stock and Class B common stock outstanding, respectively. Non-vested stock is not included in the computation of basic earnings per share until the securities vest. Diluted earnings per share for our Common stock assumes the conversion of all the Class B common stock into Common stock and adjusts for the dilutive effects of outstanding stock options and non-vested shares of stock using the treasury stock method.

For the basic earnings per share calculation, net income available to Watsco's shareholders is allocated among our two classes of common stock: Common stock and Class B common stock. The allocation among each class is based upon the two-class method on a one-for-one per share basis. The following table shows how net income is allocated using this method:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net income available to shareholders	\$82,364	\$70,019	\$48,105
Allocation of net income for Basic:			
Common stock	\$73,630	\$64,050	\$42,862
Class B common stock	8,734	5,969	5,243
	<u>\$82,364</u>	<u>\$70,019</u>	<u>\$48,105</u>

The diluted earnings per share calculation assumes the conversion of all of Watsco's Class B common stock into Common stock as of the beginning of the period, so no allocation of earnings to Class B common stock is required.

The following summarizes the weighted-average number of Common and Class B common shares outstanding during the year and is used to calculate earnings per share of Common and Class B common stock including the potentially dilutive impact of stock options and non-vested shares, calculated using the treasury method, as included in the calculation of diluted weighted-average shares:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Weighted-average Common and Class B common shares outstanding for basic earnings per share	<u>26,149,676</u>	<u>26,049,365</u>	<u>25,506,950</u>
Weighted-average Common shares outstanding for basic earnings per share	23,376,839	23,828,624	22,727,096
Diluted shares resulting from:			
Stock options	1,009,739	1,145,174	1,005,511
Non-vested stock	669,723	574,298	418,848
Effect of assuming conversion of Class B common shares into Common stock	2,772,837	2,220,741	2,779,854
Shares for diluted earnings per share	<u>27,829,138</u>	<u>27,768,837</u>	<u>26,931,309</u>

Diluted earnings per share excluded 153,500, 81,000 and 41,500 shares for the years ended December 31, 2006, 2005 and 2004, respectively, related to stock options with an exercise price per share greater than the average market value, resulting in an anti-dilutive effect on diluted earnings per share. In addition, 284,486, 60,000 and 145,000 shares for the years ended December 31, 2006, 2005 and 2004, respectively, related to non-vested stock were considered anti-dilutive.

Derivative Instruments

We apply the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the

balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in OCL and are recognized in the income statement when the hedged items affect earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings. See Note 10 for further information regarding hedging activities.

Comprehensive Income

Comprehensive income consists of net income and changes in the unrealized (losses) gains on available-for-sale securities and the effective portion of a cash flow hedge as further discussed in Note 10. The components of comprehensive income are as follows:

<i>Years Ended December 31,</i>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net income	\$82,364	\$70,019	\$48,105
Changes in unrealized losses on derivative instrument, net of income tax expense of \$205, \$534 and \$449, respectively	342	866	832
Changes in unrealized (losses) gains on available-for-sale securities arising during the period, net of income tax (expense) benefit of \$(6), \$5 and \$14, respectively	10	(10)	(25)
Less: reclassification adjustment for net securities gains realized in net income, net of income tax expense of \$0, \$40 and \$0, respectively	—	(66)	—
Comprehensive income	<u><u>\$82,716</u></u>	<u><u>\$70,809</u></u>	<u><u>\$48,912</u></u>

Recently Issued Accounting Standards

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 157, “Fair Value Measurements.” This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of SFAS No. 157 are effective for us beginning January 1, 2008. We are currently evaluating the impact of adopting SFAS No. 157 on our consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.” SAB No. 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB No. 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. SAB No. 108 permits existing public companies to initially apply its provisions either by (i) restating prior financial statements as if the “dual approach” had always been used or (ii) recording the cumulative effect of initially applying the “dual approach” as adjustments to the carrying value of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of the “cumulative effect” transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. The adoption of SAB No. 108 did not have a material impact on our consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109” (“FIN No. 48”). This interpretation clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements in accordance with SFAS No. 109, “Accounting for Income Taxes.” This interpretation seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, it requires expanded disclosure with respect to the uncertainty in income taxes. FIN No. 48 is effective January 1, 2007 and is not expected to have a material impact on our consolidated financial statements.

Reclassifications

Certain reclassifications of prior year amounts have been made to conform to the 2006 presentation. These reclassifications had no effect on net income or earnings per share as previously reported.

2. Supplier Concentration

We have seven key suppliers of HVAC equipment products. Purchases from these seven suppliers comprised 47%, 48% and 45% of all purchases made in 2006, 2005 and 2004, respectively; with the largest supplier accounting for 17% of all purchases made in each of the years ended December 31, 2006, 2005 and 2004. Any significant interruption by the suppliers or a termination of a distribution agreement could disrupt the operations of certain subsidiaries.

3. Property and Equipment

Property and equipment, net, consists of:

<u>December 31,</u>	<u>2006</u>	<u>2005</u>
Land	\$ 665	\$ 654
Buildings and improvements	19,795	16,233
Machinery, vehicles and equipment	27,542	23,842
Furniture and fixtures	18,393	18,437
	<u>66,395</u>	<u>59,166</u>
Less: accumulated depreciation and amortization	<u>(44,919)</u>	<u>(41,922)</u>
	<u>\$ 21,476</u>	<u>\$ 17,244</u>

4. Long-Term Obligations

Revolving Credit Agreement and Long-Term Notes

We maintain a bank-syndicated, unsecured revolving credit agreement that provides for borrowings of up to \$100,000, which expires in December 2009. Borrowings are used to fund seasonal working capital needs and for other general corporate purposes, including acquisitions and issuance of letters of credit. Borrowings bear interest at primarily LIBOR-based rates plus a spread that is dependent upon Watsco's financial performance (LIBOR plus .475% and .625% at December 31, 2006 and 2005, respectively). A variable commitment fee is paid on the unused portion of the credit line (.125% and .15% at December 31, 2006 and 2005, respectively). At December 31, 2006 and 2005, \$30,000 was outstanding under the revolving credit agreement.

A \$125,000 unsecured private placement shelf facility is also maintained as a source of borrowings. The uncommitted shelf facility provides fixed-rate financing through December 2007 as a complement to the variable rate borrowings available under the revolving credit agreement. \$10,000 and \$20,000, respectively, of Senior Series A Notes ("Notes") were outstanding at December 31, 2006 and 2005 under the facility bearing interest at 7.07%. The Notes will be repaid on April 9, 2007. Accordingly, \$10,000 is classified as "current" in the consolidated balance sheet at December 31, 2006. Interest is paid on a quarterly basis. The Notes may be redeemed prior to maturity subject to a redemption premium and other restrictions.

Both the revolving credit agreement and the private placement shelf facility contain customary affirmative and negative covenants including certain financial covenants with respect to consolidated leverage, interest and debt coverage ratios and limits capital expenditures, dividends and share repurchases in addition to other restrictions. We believe that we are in compliance with all covenants and financial ratios at December 31, 2006.

Other Long-Term Obligations

Other long-term obligations, net of current portion, of \$118 and \$189 at December 31, 2006 and 2005, respectively, relate to capital leases on equipment. Interest rates on other debt range from 1.0% to 8.6% and mature at varying dates through 2010. Annual maturities of other long-term obligations for the years subsequent to December 31, 2006 are \$84 in 2007, \$72 in 2008, \$41 in 2009 and \$5 in 2010.

Total cash payments for interest were \$4,345, \$4,854 and \$4,870 for the years ended December 31, 2006, 2005 and 2004, respectively.

5. Income Taxes

The components of income tax expense are as follows:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal	\$45,472	\$39,439	\$27,146
State	3,947	3,658	2,388
	<u>\$49,419</u>	<u>\$43,097</u>	<u>\$29,534</u>
Current	\$49,954	\$42,900	\$25,651
Deferred	(535)	197	3,883
	<u>\$49,419</u>	<u>\$43,097</u>	<u>\$29,534</u>

Following is a reconciliation of the effective income tax rate:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit and other	2.5	3.1	2.9
Change in valuation allowance	—	—	.1
	<u>37.5%</u>	<u>38.1%</u>	<u>38.0%</u>

The following is a summary of the significant components of Watsco's current and long-term deferred tax assets and liabilities:

<u>December 31,</u>	<u>2006</u>	<u>2005</u>
Current deferred tax assets:		
Accounts receivable reserves	\$ 1,163	\$ 1,060
Capitalized inventory costs and inventory reserves	2,572	1,564
Other current deferred tax assets	707	825
Total current deferred tax assets (1)	<u>4,442</u>	<u>3,449</u>
Long-term deferred tax assets (liabilities):		
Deductible goodwill	(16,853)	(14,006)
Net operating loss carryforwards	1,139	1,505
Unrealized loss on derivative instrument	82	294
Depreciation	1,302	472
Amortization of un-earned compensation	3,740	2,462
Self-insurance reserves	1,935	1,735
Other long-term net deferred tax assets	766	313
Total net long-term deferred tax liabilities	<u>(7,889)</u>	<u>(7,225)</u>
Less valuation allowance	<u>(408)</u>	<u>(396)</u>
Net deferred tax liabilities	<u>\$ (3,855)</u>	<u>\$ (4,172)</u>

(1) Current deferred tax assets of \$4,442 and \$3,449 have been included in the consolidated balance sheets in other current assets at December 31, 2006 and 2005, respectively.

SFAS No. 109, "Accounting for Income Taxes," requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Management has determined that \$408 of valuation allowance at December 31, 2006 is necessary to reduce the deferred tax assets to the amount that will more likely than not be realized. There was a \$12 increase in the valuation allowance for the current year. At December 31, 2006, there were state net operating loss carryforwards of \$18,714, which expire in varying amounts from 2007 through 2026. These amounts are available to offset future taxable income. There were no federal net operating loss carryforwards at December 31, 2006.

The number of years that are open for tax audit vary depending on the tax jurisdiction. A number of years may elapse before a particular matter is audited and finally resolved. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, we believe that the consolidated financial statements reflect the probable outcome of known tax contingencies.

Total cash payments, net of refunds, for income taxes were \$47,961, \$31,298 and \$22,487 for the years ended December 31, 2006, 2005 and 2004, respectively.

6. Share-Based Compensation and Benefit Plans

Share-Based Compensation Plans

At December 31, 2006, we had two share-based compensation plans for employees. The 2001 Incentive Compensation Plan (the "2001 Plan") provides for the award of a broad variety of stock-based compensation alternatives such as non-qualified stock options, incentive stock options, non-vested (restricted) stock, performance awards, dividend equivalents, deferred stock and stock appreciation rights at no less than 100% of the market price on the date the award is granted. To date, awards under the 2001 Plan consist of non-qualified stock options and non-vested stock. Under the 2001 Plan, awards for an aggregate of 3,000,000 shares of Common and Class B common stock may be granted. A total of 1,383,363 shares of Common stock, net of cancellations and 1,044,811 shares of Class B common stock, net of cancellations have been awarded under the 2001 Plan as of December 31, 2006. There were 571,826 shares of common stock reserved for future grants as of December 31, 2006 under the 2001 Plan. There are 996,958 options of common stock outstanding under the 2001 Plan at December 31, 2006.

Options under the 2001 Plan vest over two to five years of service and have contractual terms of five to ten years. Awards of non-vested stock, which are granted at no cost to the employee, vest upon attainment of a certain age, generally the employee's respective retirement age. Vesting may be accelerated in certain circumstances prior to the original vesting date. We also maintain the 1991 Stock Option Plan (the "1991 Plan"), which expired during 2001; therefore, no additional options may be granted. Options as to 1,216,988 of common stock are outstanding under the 1991 Plan at December 31, 2006. Options under the 1991 Plan vest over two to five years of service and have contractual terms of ten years.

A summary of stock option activity under the 2001 Plan and 1991 Plan as of December 31, 2006, and changes during 2006, is as follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2006	2,589,363	\$ 17.30		
Granted	99,500	61.29		
Exercised	(427,750)	15.82		
Expired	(16,200)	16.15		
Forfeited	(30,967)	31.27		
Options outstanding at December 31, 2006	<u>2,213,946</u>	<u>\$ 19.35</u>	<u>3.25</u>	<u>\$ 63,317</u>
Options exercisable at December 31, 2006	<u>1,693,313</u>	<u>\$ 13.71</u>	<u>3.00</u>	<u>\$ 56,702</u>

The weighted-average grant date fair value of stock options granted during 2006, 2005 and 2004 was \$14.99, \$11.70 and \$9.33, respectively. The total intrinsic value of stock options exercised during 2006, 2005 and 2004 was \$22,390, \$19,088 and \$7,200, respectively. The fair value of stock options vested during 2006, 2005 and 2004 was \$497, \$1,986 and \$1,915, respectively.

A summary of non-vested stock issued as of December 31, 2006, and changes during 2006, is shown below:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested stock outstanding at January 1, 2006	1,593,561	\$ 26.62
Granted	81,044	67.94
Vested	—	—
Forfeited	(2,873)	70.83
Non-vested stock outstanding at December 31, 2006	1,671,732	\$ 28.55

The weighted-average grant date fair value of non-vested stock granted during 2006, 2005 and 2004 was \$67.94, \$52.17 and \$31.86, respectively. The fair value of stock vested during 2005 and 2004 was \$348 and \$132, respectively. No non-vested stock vested during 2006.

Share-Based Compensation Fair Value Assumptions

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing valuation model based on the weighted-average assumptions noted in the following table. The fair value of the stock option awards, which are subject to graded vesting, is expensed on a straight-line basis over the vesting life of the stock options. Expected volatility is based on historical volatility of Watsco's stock. The risk-free rate for periods within the contractual life of the stock option award is based on the yield curve of a zero-coupon U.S. Treasury bond on the date the stock option award is granted with a maturity equal to the expected term of the stock option award. We use historical data to estimate stock option forfeitures within the valuation model. All of the awards granted during 2006 meet the definition of "plain vanilla" options, as defined in SEC Staff Accounting Bulletin No. 107. The expected term of stock option awards granted represents the period of time that stock option awards granted are expected to be outstanding and was calculated using the simplified method for plain vanilla options.

The weighted-average assumptions relating to the valuation of our stock options were as follows:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Expected life in years	4.25	4.00	4.77
Risk-free interest rate	4.91%	4.13%	3.40%
Expected volatility	24.08%	34.03%	36.93%
Dividend yield	1.35%	1.38%	1.33%

Share-Based Compensation Expense

The following table provides information on share-based compensation expense and tax benefits recognized:

<u>Years Ended December 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Share-based compensation expense	\$ 5,020	\$ 2,528	\$ 1,002
Income tax benefit	(1,883)	(961)	(381)
Share-based compensation expense, net of tax	<u>\$ 3,137</u>	<u>\$ 1,567</u>	<u>\$ 621</u>

Cash received from Watsco Common and Class B common stock issued as a result of stock options exercised during 2006, 2005 and 2004, was \$2,214, \$3,528 and \$5,553, respectively. During 2006 and 2005, 150,086 shares of Common stock with an aggregate market value of \$10,563 and 115,614 shares of Common stock with an aggregate market value of \$5,812, respectively, were delivered as payment in lieu of cash for stock option exercises. These shares were then retired. The actual tax benefit realized for the tax deductions from share-based compensation plans totaled \$8,396, \$7,654 and \$2,746, for the years ended December 31, 2006, 2005 and 2004, respectively.

At December 31, 2006, there was \$2,054 of unrecognized share-based compensation expense related to non-vested stock options granted under the 2001 Plan, which is expected to be recognized over a weighted-average period of 1.6 years. At December 31, 2006, there was \$37,627 of unrecognized share-based compensation expense related to non-vested stock granted, which is expected to be recognized over a weighted-average period of 11.4 years. In the event that vesting is accelerated for any circumstance, as defined in the related agreements, the remaining unrecognized share-based compensation expense would be immediately recognized as a charge to earnings. Approximately \$28,000 of the unrecognized share-based compensation for shares of non-vested stock is related to awards granted to Watsco's Chief Executive Officer that vest in approximately 11 years upon his attainment of age 78.

Share-Based Compensation Modifications

On December 28, 2005, the Compensation Committee of the Board of Directors approved the vesting acceleration of 76,616 stock options for 25 employees. The decision to accelerate vesting of these options was made primarily to reward certain key employees for their performance in 2005 and to mitigate compensation expense that would have been required upon the adoption of SFAS No. 123R.

Employee Stock Purchase Plan

Effective July 1, 1996, we adopted the Watsco, Inc. Amended and Restated 1996 Qualified Employee Stock Purchase Plan (the "Watsco ESPP") under which full-time employees with at least 90 days of service may purchase up to an aggregate of 900,000 shares of Common stock. The plan allows participating employees to purchase, through payroll deductions or lump-sum contribution, shares of Common stock at 85% of the fair market value at specified times subject to certain restrictions. In December 2005, the Watsco ESPP was amended to change the discount that employees can purchase shares of our Common stock to 5% of the fair market value and to remove certain restrictions, effective January 1, 2006. During 2006, 2005 and 2004 employees purchased 28,232, 76,632 and 54,076 shares of Common stock at an average price of \$48.88, \$31.51 and \$20.75 per share, respectively. Cash dividends received by the Watsco ESPP were reinvested in Common stock and resulted in additional shares issued in the amount of 4,162, 3,335 and 3,361 for the years ended December 31, 2006, 2005 and 2004, respectively. We received net proceeds of \$1,608, \$2,566 and \$1,215, respectively, during 2006, 2005 and 2004, for shares of Watsco Common stock issued under the Watsco ESPP. At December 31, 2006, 34,325 shares remained available for purchase under the plan.

401(k) Plan

We have a profit sharing retirement plan for our employees that is qualified under Section 401(k) of the Internal Revenue Code. Annual matching contributions are made based on a percentage of eligible employee compensation deferrals. The contribution is made in cash or by the issuance of Common stock to the plan on behalf of our employees. For the years ended December 31, 2006, 2005 and 2004, the aggregate contribution required to the plan was \$1,140, \$1,181 and \$922, respectively. This contribution is made during the first quarter of the subsequent year.

7. Acquisitions

In December 2006, one of our subsidiaries completed the acquisition of a distributor of air conditioning and heating products with 10 locations in Nebraska, Missouri and Kansas. The purchase price of the acquisition included a cash payment of approximately \$5,123.

In October 2006, one of our subsidiaries completed the acquisition of a wholesale distributor of refrigeration equipment with 8 locations in Tennessee, Mississippi and Arkansas. The purchase price of the acquisition included a cash payment of approximately \$3,675.

In March 2006, one of our subsidiaries completed the acquisition of a refrigeration equipment distributor with locations in Birmingham and Montgomery, Alabama for cash consideration of \$798, net of cash acquired.

In February 2006, one of our subsidiaries completed the purchase of the net assets and business of a wholesale distributor of air conditioning and heating products operating from a single location in Kansas City, Missouri for cash consideration of \$293, net of cash acquired.

In January 2005, Watsco acquired East Coast Metal Distributors, Inc., one of the nation's largest distributors of air conditioning and heating products, with 27 locations in North Carolina, South Carolina, Georgia, Virginia and Tennessee, for cash consideration of \$49,481, net of cash acquired, and the issuance of 145,536 shares of unregistered Common stock having a fair value of \$4,500. In connection with this acquisition, Watsco recorded \$27,083 of goodwill, all of which is expected to be deductible for tax purposes.

In April 2004, one of Watsco's subsidiaries completed the purchase of the net assets and business of two affiliated refrigeration equipment distributors with locations in Dallas and Austin, Texas. These acquisitions were funded by cash on hand totaling \$3,403.

The results of operations of these locations have been included in the consolidated financial statements from their respective dates of acquisition. The proforma effects of these acquisitions were not deemed material to the consolidated financial statements for the years ended December 31, 2006, 2005 and 2004.

8. Goodwill and Intangibles

The recoverability of goodwill and indefinite life intangibles is evaluated at least annually and when events or changes in circumstances indicate that the carrying amount of goodwill and indefinite life intangibles may not be recoverable. The identification and measurement of impairment involves the estimation of the fair value of reporting units and indefinite life intangibles and contains uncertainty because management must use judgment in determining appropriate assumptions to be used in the measurement of fair value. The estimates of fair value of the reporting units are based on the best information available as of the date of the assessment and incorporate management assumptions about expected future cash flows and contemplate other valuation techniques. Future cash flows can be affected by changes in industry or market conditions.

On January 1, 2007, the annual impairment tests were performed and it was determined there was no impairment. No factors have developed since the last impairment tests that would indicate that the carrying value of goodwill and indefinite life intangibles may not be recoverable. The carrying amount of goodwill and intangibles at December 31, 2006 was \$165,916. Although no impairment has been recorded to date, there can be no assurances that future impairments will not occur. An adjustment to the carrying value of goodwill and intangibles could materially impact the consolidated results of operations.

The changes in the carrying amount of goodwill are as follows:

Balance at December 31, 2004	\$ 131,829
Acquired goodwill	27,083
Balance at December 31, 2005	158,912
Acquired goodwill	2,195
Balance at December 31, 2006	<u>\$ 161,107</u>

Intangible assets, net, included in other assets in the consolidated balance sheets consist of:

December 31,	2006	2005
Unamortizable intangible assets:		
Trade name	\$ 4,413	\$ 4,413
Amortizable intangible assets:		
Customer relationships	210	210
Non-compete agreements	321	224
Less: accumulated amortization	(135)	(73)
Amortizable intangible assets, net	<u>396</u>	<u>361</u>
	<u>\$ 4,809</u>	<u>\$ 4,774</u>

9. Shareholders' Equity

Common stock and Class B common stock share equally in earnings and are identical in most other respects except (i) Common stock is entitled to one vote on most matters and each share of Class B common stock is entitled to ten votes; (ii) shareholders of Common stock are entitled to elect 25% of the Board of Directors (rounded up to the nearest whole number) and Class B shareholders are entitled to elect the balance of the Board of Directors; (iii) cash dividends may be paid on Common stock without paying a cash dividend on Class B common stock and no cash dividend may be paid on Class B common stock unless at least an equal cash dividend is paid on Common stock and (iv) Class B common stock is convertible at any time into Common stock on a one-for-one basis at the option of the shareholder.

Watsco's Board of Directors has authorized the repurchase, at management's discretion, of 7,500,000 shares in the open market or via private transactions. Shares repurchased under the program are accounted for using the cost method and result in a reduction of shareholders' equity. 243,600 shares were repurchased at a cost of \$15,328 in 2006, 347,600 shares at a cost of \$17,721 in 2005 and 29,900 shares at a cost of \$836 in 2004. In aggregate since the inception of the repurchase plan in 1999, 6,034,213 shares of Common stock and Class B common stock were repurchased at a cost of \$100,219. The remaining 1,465,787 shares authorized for repurchase are subject to certain restrictions included in the debt agreements.

10. Financial Instruments

Recorded Financial Instruments

Recorded financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, the current portion of long-term obligations, borrowings under revolving credit agreement and debt instruments included in other long-term obligations. At December 31, 2006 and 2005, the fair values of cash and cash equivalents, accounts receivable, accounts payable and the current portion of long-term obligations approximated their carrying values due to the short-term nature of these instruments.

The fair values of variable rate borrowings under the revolving credit agreement and debt instruments included in long-term obligations also approximate their carrying value based upon interest rates available for similar instruments with consistent terms and remaining maturities.

Derivative Financial Instruments

Periodically, we have entered into interest rate swap agreements to reduce our exposure to market risks from changing interest rates under our revolving credit agreement. Under the terms of the swap agreements, we agree to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to the notional principal amount. Any differences paid or received on our interest rate swap agreements are recognized as adjustments to interest expense over the life of each swap, thereby adjusting the effective interest rate on the underlying obligation. Financial instruments are not held or issued for trading purposes. In order to obtain hedge accounting treatment, any derivatives used for hedging purposes must be designated as, and effective as, a hedge of an identified risk exposure at the inception of the contract. Accordingly, changes in the fair value of the derivative contract must be highly correlated with changes in the fair value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties. Fair values were based on dealer quotations obtained by Watsco.

At December 31, 2006 and 2005, one interest rate swap agreement was in effect with a notional value of \$30,000 maturing in 2007. The swap agreement exchanges the variable rate of 90-day LIBOR to fixed interest rate payments of 6.25%. The interest rate swap was effective as a cash flow hedge and no charge to earnings was required for hedge ineffectiveness in 2006, 2005 or 2004. The negative fair value of the derivative financial instrument was \$279 and \$927 at December 31, 2006 and 2005, respectively, and is included, net of accrued interest, in deferred income taxes and other liabilities in the consolidated balance sheets.

At December 31, 2006, 2005 and 2004, \$136, net of deferred tax benefits of \$82, \$478 net of deferred tax benefits of \$294 and \$1,344 net of deferred tax benefits of \$829 was recorded in OCL associated with the cash flow hedge. During 2006, 2005 and 2004, we recognized decreases in unrealized losses in OCL relating to cash flow hedges of \$342, net of income tax expense of \$205, \$866, net of income tax expense of \$534 and \$832, net of income tax expense of \$449, respectively.

The net change in OCL during 2006, 2005 and 2004, reflected the reclassification of \$221, net of income tax benefit of \$132, \$555, net of income tax benefit of \$342 and \$905, net of income tax benefit of \$556, respectively, of unrealized losses from accumulated OCL to current period earnings (recorded in interest expense, net in the consolidated statements of income). The net unrealized loss recorded in accumulated OCL will be reclassified to earnings on a quarterly basis as interest payments occur. We estimate that approximately \$300 in unrealized losses on the derivative instrument accumulated in OCL is expected to be reclassified to earnings during 2007 using a current three month LIBOR-based average receive rate (5.17% at December 31, 2006).

Off-Balance Sheet Financial Instruments

At December 31, 2006 and 2005, we were contingently liable under standby letters of credit aggregating \$4,078 and \$4,346, respectively that are primarily used as collateral to cover any contingency related to additional risk assessments pertaining to the self-insurance programs. We do not expect any material losses to result from the issuance of the standby letters of credit because claims are not expected to exceed premiums paid. Accordingly, the estimated fair value of these instruments is zero.

Concentrations of Credit Risk

Financial instruments which potentially subject us to concentrations of credit risk consist principally of cash investments and accounts receivable. Temporary cash investments are placed with high credit quality financial institutions and we limit the amount of credit exposure to any one financial institution or investment. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers comprising the customer base and their dispersion across many different geographical regions.

11. Commitments and Contingencies

Litigation, Claims and Assessments

We are involved in litigation incidental to the operation of our business and we vigorously defend all matters in which Watsco or its subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments that may affect us. In our opinion, although the adequacy of existing insurance coverage or the outcome of any legal proceedings cannot be predicted with certainty, the ultimate liability associated with any claims or litigation in which Watsco or its subsidiaries are involved will not materially affect our financial condition or results of operations.

Self-Insurance

Self-insurance reserves are maintained relative to company-wide casualty insurance programs and for one subsidiary's health benefit program. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverages. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occurs and exceed these estimates, additional reserves may be required. The estimation process contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. Reserves of \$5,664 at December 31, 2006 and \$5,203 at December 31, 2005 were established related to such insurance programs.

Variable Interest Entities

As of December 31, 2006, in conjunction with our casualty insurance programs, limited equity interests is held in one captive insurance entity. The programs permit us to self-insure a portion of losses, to gain access to a wide array of safety-related services, to pool insurance risks and resources in order to obtain more competitive pricing for administration and reinsurance and to limit its risk of loss in any particular year. The entities meet the definition of variable interest entities ("VIEs"), however, based on the criteria set forth in FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51," there is not a requirement to include these entities in the consolidated financial statements. The maximum exposure to loss related to our involvement with these entities is limited to approximately \$6,440. See Note 11, "Self-Insurance," for additional discussion of commitments associated with the insurance programs and Note 10, "Off-Balance Sheet Financial Instruments," for further information on standby letters of credit. As of December 31, 2006, there are no other entities that met the definition of a VIE.

Minimum Royalty Payments

We are obligated under a licensing agreement with Whirlpool Corporation to make minimum annual royalty payments of \$1,000 through 2011.

Operating Leases

At December 31, 2006, we are obligated under non-cancelable operating leases of real property, equipment, vehicles and a corporate aircraft used in our operations for minimum annual rentals of \$39,230 in 2007, \$32,514 in 2008, \$25,020 in 2009, \$17,216 in 2010, \$10,880 in 2011 and \$17,671 thereafter. Some of our leases contain renewal options, some of which involve rate increases. For leases with step rent provisions whereby the rental payments increase incrementally over the life of the lease, we recognize the total minimum lease payments on a straight-line basis over the lease term. The corporate aircraft lease is subject to adjustment from changes in LIBOR-based interest rates. Rental expense for the years ended December 31, 2006, 2005 and 2004 was \$36,804, \$34,360 and \$27,835, respectively.

12. Segment Information

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," requires companies to provide certain information about their operating segments. Watsco has one reportable segment: the distribution of HVAC equipment and related

parts and supplies—which comprises 98%, 99% and 98% of revenues in 2006, 2005 and 2004, respectively. Our other segment represents our temporary staffing and permanent placement services business.

The segment information presented below follows the same accounting policies used for the consolidated financial statements as described in Note 1. Costs excluded from this profit measure are interest expense, net and income taxes. Corporate expenses are primarily comprised of corporate overhead expenses. Thus, operating income includes only the costs that are directly attributable to the operations of the individual segment. Assets not identifiable to an individual segment are corporate assets, which are primarily comprised of cash and cash equivalents, deferred taxes and certain property and equipment.

<i>Years Ended December 31,</i>	2006	2005	2004
Revenues:			
Distribution	\$1,771,214	\$1,658,249	\$1,294,715
Other	29,912	25,292	21,251
Elimination of intersegment revenues	(367)	(817)	(942)
Revenues from external customers	\$1,800,759	\$1,682,724	\$1,315,024
Operating income (loss):			
Distribution	\$ 154,371	\$ 134,577	\$ 100,818
Other	209	(10)	(1,100)
Corporate expenses	(18,977)	(18,109)	(17,666)
	\$ 135,603	\$ 116,458	\$ 82,052
Depreciation and amortization:			
Distribution	\$ 5,555	\$ 5,737	\$ 5,029
Other	122	119	155
Corporate	231	333	1,584
	\$ 5,908	\$ 6,189	\$ 6,768
Assets:			
Distribution	\$ 654,498	\$ 619,998	\$ 499,771
Other	7,581	7,235	8,861
Corporate	49,292	51,498	99,657
	\$ 711,371	\$ 678,731	\$ 608,289
Capital expenditures:			
Distribution	\$ 7,379	\$ 7,104	\$ 4,118
Other	108	56	157
Corporate	2,505	123	571
	\$ 9,992	\$ 7,283	\$ 4,846

13. Related Party Transactions

A member of the Board of Directors is the President and Chief Executive Officer of Greenberg Traurig, P.A., which serves as our principal outside counsel and receives customary fees for legal services. During 2006, 2005 and 2004, this firm was paid \$295, \$172 and \$89, respectively, for services performed.

14. Subsequent Event

In February 2007, Watsco's Board of Directors approved an increase in the quarterly cash dividend to 33 cents per share from 25 cents per share.

WATSCO, INC. AND SUBSIDIARIES
SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

<i>(In thousands, except per share data)</i>	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Year Ended December 31, 2006					
Revenues (1)	\$ 394,307	\$ 512,029	\$ 506,858	\$ 387,565	\$ 1,800,759
Gross profit	100,080	132,488	133,213	97,119	462,900
Net income (2)	<u>\$ 13,047</u>	<u>\$ 28,748</u>	<u>\$ 29,051</u>	<u>\$ 11,519</u>	<u>\$ 82,364</u>
Earnings per share for Common and Class B common stock (2)					
Basic	\$ 0.50	\$ 1.10	\$ 1.11	\$ 0.44	\$ 3.15
Diluted	<u>\$ 0.47</u>	<u>\$ 1.03</u>	<u>\$ 1.05</u>	<u>\$ 0.42</u>	<u>\$ 2.96</u>
Year Ended December 31, 2005					
Revenues (1)	\$ 345,952	\$ 443,030	\$ 477,553	\$ 416,189	\$ 1,682,724
Gross profit	87,425	111,525	120,118	103,962	423,030
Net income (2)	<u>\$ 9,148</u>	<u>\$ 22,406</u>	<u>\$ 24,347</u>	<u>\$ 14,118</u>	<u>\$ 70,019</u>
Earnings per share for Common and Class B common stock (2)					
Basic	\$ 0.35	\$ 0.86	\$ 0.94	\$ 0.54	\$ 2.69
Diluted	<u>\$ 0.33</u>	<u>\$ 0.81</u>	<u>\$ 0.88</u>	<u>\$ 0.50</u>	<u>\$ 2.52</u>

- (1) Sales of residential central air conditioners, heating equipment and related parts and supplies are seasonal. Demand related to the residential central air conditioning replacement market is highest in the second and third quarters with demand for heating equipment usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly even during the year except for dependence on housing completions and related weather and economic conditions.
- (2) Quarterly earnings per Common and Class B common share are calculated on an individual basis and, because of rounding and changes in the weighted average shares outstanding during the year, the summation of each quarter may not equal the amount calculated for the year as a whole.

WATSCO, INC. AND SUBSIDIARIES
INFORMATION ON COMMON STOCK

Watsco Common stock is traded on the New York Stock Exchange under the symbol WSO and our Class B common stock is traded on the American Stock Exchange under the symbol WSOB. The following table indicates the high and low prices of our Common stock and Class B common stock, as reported by the New York Stock Exchange and American Stock Exchange, respectively, and dividends paid per share for each quarter during the years ended December 31, 2006 and 2005. At February 15, 2007, excluding shareholders with stock in street name, there were 346 Common stock shareholders of record and 151 Class B common stock shareholders of record.

	<u>Common</u>		<u>Class B</u>		<u>Cash Dividend</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>	<u>Common</u>	<u>Class B</u>
Year Ended December 31, 2006:						
Fourth quarter	\$53.75	\$45.08	\$53.53	\$45.39	\$.25	\$.25
Third quarter	60.80	42.20	60.50	42.50	.25	.25
Second quarter	70.60	52.35	72.00	53.47	.25	.25
First quarter	<u>72.25</u>	<u>63.24</u>	<u>73.05</u>	<u>63.50</u>	<u>.20</u>	<u>.20</u>
Year Ended December 31, 2005:						
Fourth quarter	\$66.90	\$49.19	\$66.51	\$50.00	\$.20	\$.20
Third quarter	53.11	40.46	52.60	41.75	.14	.14
Second quarter	45.81	39.15	45.55	40.50	.14	.14
First quarter	<u>42.11</u>	<u>34.03</u>	<u>42.25</u>	<u>33.50</u>	<u>.14</u>	<u>.14</u>

REGISTRANT'S SUBSIDIARIES

The following table sets forth, at February 28, 2007, the Registrant's significant operating subsidiaries and other associated companies and their respective incorporation jurisdictions. The Registrant owns 100% of the voting securities of each of the subsidiaries listed below. There are no subsidiaries not listed in the table, which would, in the aggregate, be considered significant.

<u>Active Subsidiaries</u>	<u>State of Incorporation</u>
Distribution:	
Air Systems Distributors LLC	Delaware
Atlantic Service & Supply LLC	Delaware
Baker Distributing Company LLC	Delaware
Comfort Supply, Inc.	Delaware
Comfort Products Distributing LLC	Delaware
East Coast Metal Distributors LLC	Delaware
Gemaire Distributors LLC	Delaware
Heat Incorporated LLC	New Hampshire
Heating & Cooling Supply LLC	California
Homans Associates LLC	Delaware
Three States Supply Company LLC	Tennessee
Tradewinds Distributing Company LLC	Delaware
Watsco Holdings, Inc.	Delaware
Other:	
Dunhill Staffing Systems, Inc.	Delaware
Dunhill Temporary Systems, Inc.	New York

Consent of Independent Registered Public Accounting Firm

We have issued our reports dated March 1, 2007, with respect to the consolidated financial statements of Watsco, Inc. and subsidiaries (which report expressed an unqualified opinion and contains an explanatory paragraph relating to the adoption of FAS 123(R), "Share-Based Payment") and Watsco Inc. and subsidiaries management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting of Watsco, Inc. and subsidiaries, included in the 2006 Annual Report to Shareholders of Watsco, Inc. and subsidiaries. We hereby consent to the incorporation by reference in this Annual Report (Form 10-K) of Watsco, Inc. and subsidiaries of the aforementioned reports.

We hereby consent to the incorporation by reference of the aforementioned reports in the following Registration Statements:

- (1) Registration Statement (Form S-3 No. 33-7758, No. 33-37982, No. 333-00371, No. 333-01441 and No. 333-19803) of Watsco, Inc. and subsidiaries,
- (2) Registration Statement (Form S-8 No. 333-10363, No. 333-80341, No. 333-39380 and No. 333-126824) pertaining to the Watsco, Inc. Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan,
- (3) Registration Statement (Form S-8 No. 333-82011, No. 33-51934 and No. 33-72798) pertaining to the Watsco, Inc. Amended and Restated 1991 Stock Option Plan, and
- (4) Registration Statement (Form S-8 No. 333-86006) pertaining to the 2001 Incentive Compensation Plan;

/s/ GRANT THORNTON LLP

Miami, Florida
March 1, 2007

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in this Annual Report (Form 10-K) of Watsco, Inc. and subsidiaries of our report dated March 14, 2005, with respect to the consolidated financial statements of Watsco, Inc. and subsidiaries for the year ended December 31, 2004, included in the 2006 Annual Report to Shareholders of Watsco, Inc. and subsidiaries.

We consent to the incorporation by reference in the following Registration Statements:

- (1) Registration Statement (Form S-3 No. 33-7758, No. 33-37982, No. 333-00371, No. 333-01441 and No. 333-19803) of Watsco, Inc. and subsidiaries,
- (2) Registration Statement (Form S-8 No. 333-10363, No. 333-80341, No. 333-39380 and No. 333-126824) pertaining to the Watsco, Inc. Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan,
- (3) Registration Statement (Form S-8 No. 333-82011, No. 33-51934 and No. 33-72798) pertaining to the Watsco, Inc. Amended and Restated 1991 Stock Option Plan, and
- (4) Registration Statement (Form S-8 No. 333-86006) pertaining to the 2001 Incentive Compensation Plan;

of our report dated March 14, 2005, with respect to the consolidated financial statements of Watsco Inc. and subsidiaries for the year ended December 31, 2004, incorporated herein by reference, and our report with respect to the financial statement schedule of Watsco, Inc. and subsidiaries for the year ended December 31, 2004, included in this Annual Report (Form 10-K) of Watsco, Inc. and subsidiaries.

/s/ ERNST & YOUNG LLP
Certified Public Accountants

Miami, Florida
February 27, 2007

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Albert H. Nahmad, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 1, 2007

/s/ Albert H. Nahmad

Albert H. Nahmad

Chief Executive Officer

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Barry S. Logan, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 1, 2007

/s/ Barry S. Logan

Barry S. Logan

Senior Vice President

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Ana M. Menendez, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 1, 2007

/s/ Ana M. Menendez

Ana M. Menendez
Chief Financial Officer

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Watsco, Inc. ("Watsco") on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Albert H. Nahmad, the Chief Executive Officer of Watsco, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Watsco.

/s/ Albert H. Nahmad

Albert H. Nahmad

Chief Executive Officer

March 1, 2007

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watsco and will be retained by Watsco and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by Watsco for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Watsco, Inc. ("Watsco") on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Barry S. Logan, the Senior Vice President of Watsco, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Watsco.

/s/ Barry S. Logan

Barry S. Logan
Senior Vice President
March 1, 2007

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watsco and will be retained by Watsco and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by Watsco for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Watsco, Inc. ("Watsco") on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Ana M. Menendez, the Chief Financial Officer of Watsco, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Watsco.

/s/ Ana M. Menendez

Ana M. Menendez

Chief Financial Officer

March 1, 2007

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watsco and will be retained by Watsco and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by Watsco for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.