

**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, 2005

**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, 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:**

Title of each class	Name of each exchange on which registered
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, 2005, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$991 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, 2005 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 28, 2006 was 24,178,005 shares of Common stock, excluding treasury shares of 5,795,650, and 3,550,549 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, 2005, 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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## 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 have two business segments – the HVAC distribution (“Distribution”) segment, which accounted for 99% of 2005 consolidated revenues and presently operates from 356 locations in 31 states, and a temporary staffing and permanent placement services (“Staffing”) segment, which accounted for 1% of 2005 consolidated revenues. Our revenues have increased from \$80 million in 1989 to over \$1.68 billion in 2005 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](http://www.watsco.com) and e-mails may be sent to [info@watsco.com](mailto: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.

According to data published by the Air Conditioning and Refrigeration Institute (“ARI”) and Gas Appliance Manufacturers Association, 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 5.4% since 1995. 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, 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, Heatcraft Refrigeration Products, LLC, 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

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locations to better serve our customers, the exchange of ideas and business concepts amongst the executive management team and 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 47 HVAC distribution businesses, 6 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, York 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. Historically, the ability to expand product offerings of HVAC equipment was dependent on the granting of distribution rights by the industry's major manufacturers. In 1999, the "Grandaire" brand was created and introduced as our first private-label brand of equipment, positioned as a value-oriented brand. Grandaire-brand equipment, manufactured by Nordyne and Rheem, is currently being distributed from 168 locations in the United States. We have also entered into a ten-year exclusive licensing arrangement with Whirlpool Corporation (the "Whirlpool Licensing Agreement"), the nation's leading manufacturer of appliances, for a line of Whirlpool®-branded HVAC equipment, which was introduced in 2003 and targeted at both the residential replacement and new homebuilding markets. The line of Whirlpool®-branded HVAC equipment, manufactured by Lennox, is presently offered at 133 locations. 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 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.

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### 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**

### **Distribution Segment**

#### 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 52%, 51% and 50% of revenues for the years ended December 31, 2005, 2004 and 2003, respectively. Sales of parts and supplies (currently sourced from over 1,500 vendors) comprised 47%, 47% and 48% of revenues for such periods, respectively.

#### Distribution and Sales

We currently operate from 356 locations, most 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 806 trucks or by making products available for pick-up at the location nearest to the customer. Watsco has approximately 397 commissioned salespeople, averaging 11 years or more of experience in the air conditioning, heating and refrigeration distribution industry.

#### Markets

Watsco's network serves 31 states from these 356 locations. Primary markets include (the number of locations in the state are in parentheses): Florida (71), Texas (66), Georgia (32), California (29), North Carolina (26), South Carolina (23), Tennessee (17), Alabama (11), Virginia (11) and Louisiana (10). Locations also reside in Arizona, Massachusetts, Mississippi, Arkansas, Missouri, Kansas, Oklahoma, Iowa, Kentucky, Maine, New Hampshire, New York, South Dakota, Connecticut, Maryland, Nebraska, Nevada, New Jersey, North Dakota, Rhode Island and Vermont. 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 38,000 customers. No single customer in 2005, 2004 or 2003 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, York and Lennox, each a leading manufacturer of residential central air conditioning and heating equipment in the United States. Each manufacturer has a

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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 48%, 45% and 44% of purchases in 2005, 2004 and 2003, respectively, were made from the seven key equipment suppliers. The largest supplier accounted for 17%, 17% and 15% of all purchases made in 2005, 2004 and 2003, respectively. A 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 each of the seven 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.

### **Staffing Segment**

Watsco's Staffing segment consists of Dunhill Staffing Systems, Inc. and its subsidiaries ("Dunhill"). Dunhill was founded in 1952. Through company-owned, licensed and franchised offices, Dunhill provides temporary staffing and permanent placement services to businesses (including the Distribution segment), professional and service organizations, government agencies, health care providers and other employers. Dunhill's operations primarily consist of ten company-owned and nine licensed temporary staffing offices, as well as 56 franchised permanent placement offices and two franchised temporary staffing offices. Dunhill's franchisees operate their businesses autonomously within the framework of Dunhill's policies and standards and recruit, employ and pay their own employees, including temporary employees. Dunhill's permanent placement division recruits primarily middle management, sales, technical, administrative and support personnel for permanent employment in a wide variety of industries and positions.

### **Employees**

There were approximately 3,200 employees as of December 31, 2005, substantially all of which are non-union employees 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. 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

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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 is also subject to a Department of Energy mandate that requires, 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 is currently taking place as 13 SEER products are being introduced during the first quarter of 2006 and are expected to be fully available during the second quarter of 2006. Although the new standard does not prohibit our sale or our customers' installation of products below 13 SEER efficiency after such date (only the production), our successful transition to the new standard is subject to timely product availability from our key equipment suppliers that conform with the mandate at competitive prices, terms and conditions.

### **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 450 Fifth Street, NW, 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](http://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](http://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 48% of all purchases made in 2005 with the largest supplier accounting for 17% of all purchases made in 2005. 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 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.

##### Temporary Staffing Services



The Staffing segment (representing 1% of revenues in 2005) derives 92% of its revenues from temporary staffing services, which are sensitive to changes in the level of economic activity. Significant declines in demand for temporary staffing services would negatively impact the Staffing segment's operating results and could impact underlying asset carrying values.

## **General Risk Factors**

### 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

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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 health benefits and casualty insurance programs 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.

### Goodwill and Intangibles

At December 31, 2005, goodwill and intangibles represented approximately 24% 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. The operating results of the Staffing segment have been negatively impacted by lower demand for services during the past five years. Significant cost-savings measures have been executed in response to the business environment. Should the Staffing segment's operating results materially deteriorate, an impairment charge may be necessary to the extent that the implied fair value of goodwill is less than the carrying value. Although no impairment has been recorded to date, there can be no assurances that future impairments will not occur.

### Control by Existing Shareholder

As of December 31, 2005, 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.

### 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 expectations and are subject to a number of risks and uncertainties, 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 the Watsco's Annual Report to Shareholders for the fiscal year ended December 31, 2005 in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of

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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, 2005, the Distribution segment operated 352 warehousing and distribution facilities across 31 states in the United States having approximately 6.8 million square feet of space in the aggregate of which approximately 6.5 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, 2005, the Distribution segment operated 806 ground transport vehicles, including delivery and pick-up trucks, vans and tractors. Of this number, 442 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 leased space. The Staffing segment operates from 11 locations, with an aggregate of approximately 24,000 square feet, all of which are leased. The majority of these leases are for terms of 3 to 5 years.

During 2005, our capital expenditures were \$7.3 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, 2005.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Page 47 of the 2005 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, 2005 and 2004, and is incorporated herein by reference.

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

The following table provides information for the quarter ended December 31, 2005 with respect to any purchase made by or on behalf of Watsco or any affiliated purchaser of shares of any class of Watsco equity securities.

Period	Issuer Purchases of Equity Securities			Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (at end of period)(1)
	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	
October 1 – 31, 2005	—	—	—	1,861,787
November 1 – 30, 2005	—	—	—	1,861,787
December 1 – 31, 2005	152,400	\$ 59.75	152,400	1,709,387
Total	152,400	\$ 59.75	152,400	1,709,387

- (1) 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 in the open market or via private transactions. Through December 31, 2005, 5.8 million shares of Common and Class B common stock have been repurchased at a cost of \$85.0 million since the inception of the program. The remaining 1.7 million shares authorized for repurchase are subject to certain restrictions included in the debt agreements.

**Recent Sales of Unregistered Securities**

No sales of unregistered securities were made during the fourth quarter of the year ended December 31, 2005.

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### **Dividends**

Cash dividends of 62 cents, 38 cents and 20 cents per share of Common stock and Class B common stock were paid in 2005, 2004 and 2003, respectively. 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 48 of the 2005 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 8 through 18 of the 2005 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 2005 Annual Report contains "Quantitative and Qualitative Disclosures About Market Risk" and is incorporated herein by reference.

### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Pages 20, 21 and 23 through 45 of the 2005 Annual Report contain the 2005 and 2004 Consolidated Balance Sheets and other consolidated financial statements for the years ended December 31, 2005, 2004 and 2003, together with the reports thereon (for the applicable periods covered by their reports) of Grant Thornton LLP dated March 15, 2006 and Ernst & Young LLP dated March 14, 2005, and are incorporated herein by reference.

Page 46 of the 2005 Annual Report contains "Selected Quarterly Financial Data" for 2005 and 2004 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 Board of Directors of the Company and its Audit Committee 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.

### **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, 2005, 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 19 and 22 of the 2005 Annual Report contain "Management's Report on Internal Control Over Financial Reporting" and the report thereon of Grant Thornton LLP dated March 15, 2006, and are incorporated herein by reference.

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**Changes in Internal Control Over Financial Reporting**

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, 2005, that have materially affected, or are reasonably likely to materially affect, Watsco's internal controls over financial reporting.

**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 2005 Annual Report of Watsco, Inc.):	
Management's Report on Internal Control Over Financial Reporting	19
Report of Independent Registered Public Accounting Firm on the Financial Statements – Grant Thornton LLP	20
Report of Independent Registered Public Accounting Firm on the Financial Statements – Ernst & Young LLP	21
Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting – Grant Thornton LLP	22
Consolidated Statements of Income for the years ended December 31, 2005, 2004 and 2003	23
Consolidated Balance Sheets as of December 31, 2005 and 2004	24
Consolidated Statements of Shareholders' Equity for the years ended December 31, 2005, 2004 and 2003	25
Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003	26
Notes to Consolidated Financial Statements	27-45
Selected Quarterly Financial Data (Unaudited)	46
	<u>Page No. in Form 10-K</u>
(2) Consolidated Financial Statement Schedule for the three years ended December 31, 2005, 2004 and 2003	
<a href="#">Report of Independent Registered Public Accounting Firm on Schedule – Grant Thornton LLP</a>	S-1
<a href="#">Report of Independent Registered Public Accounting Firm on Schedule – Ernst &amp; Young LLP</a>	S-2
<a href="#">Schedule II. Valuation and Qualifying Accounts</a>	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.

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- (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). +\*
  - 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).

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- 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. #
- 10.14 First Amendment to Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan dated December 15, 2005. +#
- 10.15 Amendment to the Watsco, Inc. Profit Sharing Retirement Plan and Trust dated January 1, 2006. +#
- 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. +\*#
- 13. 2005 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 2005 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. #
- 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. #

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### 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 16, 2006

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

March 16, 2006

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 16, 2006
<u>/s/ Barry S. Logan</u> Barry S. Logan	Senior Vice President	March 16, 2006
<u>/s/ Ana M. Menendez</u> Ana M. Menendez	Chief Financial Officer (principal accounting officer and principal financial officer)	March 16, 2006
<u>/s/ Cesar L. Alvarez</u> Cesar L. Alvarez	Director	March 16, 2006
<u>/s/ Robert H. Dickinson</u> Robert H. Dickinson	Director	March 16, 2006
<u>/s/ Frederick H. Joseph</u> Frederick H. Joseph	Director	March 16, 2006
<u>/s/ Victor M. Lopez</u> Victor M. Lopez	Director	March 16, 2006
<u>/s/ Paul F. Manley</u> Paul F. Manley	Director	March 16, 2006
<u>/s/ Bob L. Moss</u> Bob L. Moss	Director	March 16, 2006
<u>/s/ George P. Sape</u> George P. Sape	Director	March 16, 2006
<u>/s/ Sherwood M. Weiser</u> Sherwood M. Weiser	Director	March 16, 2006

**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 as of December 31, 2005 and for the year then ended, and have issued our report thereon dated March 15, 2006 (included elsewhere in this Form 10-K). Our audit also included the financial statement schedule 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/ GRANT THORNTON LLP

Miami, Florida  
March 15, 2006

**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 as of December 31, 2004 and for each of the two years in the period ended December 31, 2004, and have issued our report thereon dated March 14, 2005 (included elsewhere in this Form 10-K). Our audits also included the financial statement schedule for each of the two years in the period 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 audits.

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

WATSCO, INC.  
SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS  
For the Years Ended December 31, 2005, 2004 and 2003  
(In thousands)

**Allowance for Doubtful Accounts:**

BALANCE, December 31, 2002	\$ 3,758
Additions charged to costs and expenses	3,628
Write-offs, net	<u>(4,358)</u>
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	<u>\$ 3,019</u>

**Valuation Allowance for Deferred Income Taxes:**

BALANCE, December 31, 2002	\$ 505
Deductions credited to income tax expense	<u>(181)</u>
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	<u>\$ 396</u>

Exhibit Index

<u>Exhibit No.</u>	<u>Description</u>
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.
10.14	First Amendment to Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan dated December 15, 2005.
10.15	Amendment to the Watsco, Inc. Profit Sharing Retirement Plan and Trust dated January 1, 2006.
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.
13	2005 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 2005 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.
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31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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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.

**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 HERETO,**  
**SUNTRUST BANK,**  
**as Administrative Agent,**  
**BANK OF AMERICA, N.A.,**  
**as Syndication Agent,**  
**and**  
**MIZUHO CORPORATE BANK, LTD.,**  
**as Documentation Agent**  
**SUNTRUST ROBINSON HUMPHREY CAPITAL MARKETS,**  
**A DIVISION OF SUNTRUST CAPITAL MARKETS, INC.**  
**as Lead Arranger and Book Manager**

**AMENDMENT NO. 1**  
**TO**  
**REVOLVING CREDIT AGREEMENT**

**THIS AMENDMENT NO. 1 TO REVOLVING CREDIT AGREEMENT** (this "**Amendment**") is made and entered into as of December 1, 2005, by and among WATSCO, INC., a Florida corporation (the "**Borrower**"), the several banks and other financial institutions from time to time party hereto (the "**Lenders**"), and SUNTRUST BANK, in its capacity as Administrative Agent for the Lenders (the "**Administrative Agent**").

**WITNESSETH:**

**WHEREAS**, the Borrower, the Lenders and the Administrative Agent are parties to that certain Revolving Credit Agreement, dated as of December 10, 2004 (the "**Existing Credit Agreement**"), pursuant to which the Lenders have agreed to establish a \$100,000,000 senior revolving credit facility with a \$15,000,000 swingline and a \$10,000,000 letter of credit sub-facility thereunder for the Borrower, all upon the terms and subject to the conditions specified in the Existing Credit Agreement; and

**WHEREAS**, upon request of the Borrower, the Lenders and the Administrative Agent have agreed to increase the letter of credit sub-facility to \$25,000,000 and, in connection therewith, to modify and amend the Existing Credit Agreement as set forth herein.

**NOW, THEREFORE**, in consideration of the premises and the mutual covenants and agreements herein contained, the Borrower, the Lenders and the Administrative Agent agree as follows:

**ARTICLE I**  
**DEFINITIONS**

**Section 1.1 Certain Definitions.** Unless otherwise defined herein or the context otherwise requires, the following terms as used in this Amendment, including the preamble and recitals, have the meanings set forth below:

"**Amended Credit Agreement**" shall mean the Existing Credit Agreement, as amended hereby.

"**Amendment No. 1 Effective Date**" shall have the meaning assigned to such term in Article III.

**Section 1.2 Other Definitions.** Unless otherwise defined herein, capitalized terms used herein and not defined herein shall have the meanings assigned to such terms in the Existing Credit Agreement.

**ARTICLE II**  
**AMENDMENTS TO EXISTING AGREEMENT**

Effective as of the Amendment No. 1 Effective Date, the Existing Credit Agreement is hereby amended in accordance with this Article II as follows:

**Section 2.1 Amendment to Section 1.1.** Section 1.1 – Definitions under “ARTICLE I – DEFINITIONS; CONSTRUCTION” of the Existing Credit Agreement is hereby amended by deleting the definition of “**LC Commitment**” in its entirety and inserting in lieu thereof the following new definition:

“**LC Commitment**” shall mean that portion of the Aggregate Revolving Commitments that may be used by the Borrower for the issuance of Letters of Credit in an aggregate face amount not to exceed \$25,000,000.

**Section 2.2 Addition of Subsidiary.** Borrower, in accordance with Section 5.10 of the Existing Credit Agreement, has notified the Administrative Agent of the formation of a new Subsidiary, Tradewinds Flight Services LLC, a Delaware limited liability company (“New Subsidiary”) and, as required by such Section, New Subsidiary has become a Subsidiary Loan Party by executing and delivering to Administrative Agent agreements in the form of Annex I to Exhibit D and Annex I to Exhibit E of the Existing Credit Agreement, and in addition to executing this Amendment, New Subsidiary has delivered, or will deliver, to Administrative Agent such similar documents applicable to such New Subsidiary required under Section 3.1(b)(iv), (v), (vi), (viii), (x) and (xi) as may be requested by the Administrative Agent.

**ARTICLE III**  
**CONDITIONS TO EFFECTIVENESS**

This Amendment shall be and become effective as of the date hereof (the “**Amendment No. 1 Effective Date**”) when all of the conditions set forth in this Article IV shall have been satisfied, as reasonably determined by the Administrative Agent, and thereafter, this Amendment shall be known, and may be referred to, as “**Amendment No. 1**”:

**Section 3.1 Approval by Required Lenders.** The Required Lenders shall have approved the modifications and amendments set forth in this Amendment, such approval to be evidenced by such Required Lenders’ execution of counterparts of this Amendment as set forth in Section 3.2.

**Section 3.2 Execution of Counterparts.** The Administrative Agent shall have received (including by telecopy) counterparts of this Amendment that shall have been duly executed on behalf of the Borrower, the Administrative Agent and the Required Lenders.

**Section 3.3 Legal Details, Etc.** All documents executed or submitted pursuant hereto shall be reasonably satisfactory in form and substance to the Administrative Agent and its counsel prior to or by the time of closing. Prior to or by the time of closing, the Administrative Agent and its counsel shall have received all information, legal opinions and other documents, and such counterpart originals or such certified or other copies of such originals as the Administrative Agent or its counsel may reasonably request, and all legal matters incident to the transactions contemplated by this Amendment shall be reasonably satisfactory to the Administrative Agent and its counsel.

**Section 3.4 Payment of Other Fees and Expenses.** The Borrower shall have paid all out-of-pocket costs and expenses of the Administrative Agent, including the reasonable fees, charges and disbursements of counsel for the Administrative Agent, in connection with the preparation, execution and delivery of this Amendment.

**ARTICLE IV**  
**MISCELLANEOUS**

**Section 4.1 Representations and Warranties.** The Borrower hereby represents and warrants to the Administrative Agent and the Lenders that, after giving effect to this Amendment, (a) no Default or Event of Default exists under the Existing Credit Agreement or any of the other Loan Documents, (b) all representations and warranties of each Loan Party set forth in the Loan Documents are true and correct in all material respects on and as of the date hereof (except for those which expressly relate to an earlier date), (c) since the date of the most recent financial statements of the Borrower described in Section 5.1(a) or (b) of the Existing Credit Agreement, there has been no change which has had or could reasonably be expected to have a Material Adverse Effect, and (d) the Loan Documents are legal, valid and binding obligations of the respective Loan Parties and are enforceable by the Administrative Agent and the Lenders, as applicable, against such Loan Parties in accordance with their respective terms.



**Section 4.2 Cross References.** References in this Amendment to any Section are, unless otherwise specified, to such Section of this Amendment.

**Section 4.3 Instrument Pursuant to Existing Credit Agreement.** This Amendment is a document executed pursuant to the Existing Credit Agreement and shall (unless otherwise expressly indicated therein) be construed, administered and applied in accordance with the terms and provisions of the Existing Credit Agreement.

**Section 4.4 Loan Documents.** The Borrower hereby confirms and agrees that the Loan Documents are, and shall continue to be, in full force and effect and hereby ratifies and approves in all respects its obligations thereunder, except that, upon the effectiveness of, and on and after the date of this Amendment, all references in each Loan Document to the "**Credit Agreement**", "thereunder", "thereof" or words of like import referring to the Existing Credit Agreement shall mean the Amended Credit Agreement.

**Section 4.5 Counterparts, Effectiveness, Etc.** This Amendment may be executed by the parties hereto in several counterparts, each of which shall be deemed to be an original and all of which shall constitute together but one and the same agreement. The parties may execute facsimile copies of this Amendment and the facsimile signature of any such party shall be deemed an original and fully binding on said party; provided, any party executing this Amendment by facsimile signature agrees to promptly provide ten (10) original executed copies of this Amendment to Administrative Agent.

**Section 4.6 Governing Law; Etc.** This Amendment shall be governed by and construed in accordance with the applicable terms and provisions of Section 10.5 - Governing Law; Jurisdiction; Consent to Service of Process of "ARTICLE X – MISCELLANEOUS" of the Existing Credit Agreement, which terms and provisions are incorporated herein by reference.

**Section 4.7 No Other Modifications.** Except as hereby amended, no other term, condition or provision of the Existing Credit Agreement shall be deemed modified or amended, and this Amendment shall not be considered a novation.

**Section 4.8 Successors and Assigns.** This Amendment shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

*[Balance of page intentionally left blank]*

**IN WITNESS WHEREOF**, the parties hereto have caused this Amendment to be executed (under seal in the case of the Borrower) by their respective duly authorized officers as of the day and year first above written.

**WATSCO, INC.**

By: /s/ Ana M. Menendez  
Name: Ana M. Menendez  
Title: Vice President and Chief Financial Officer

[SEAL]

**SUNTRUST BANK, as Administrative Agent, as Issuing Bank, as Swingline Lender and as a Lender**

By: /s/ Ellyn S. Rivkees  
Name: Ellyn S. Rivkees  
Title: Managing Director

Revolving Commitment: \$22,500,000

Swingline Commitment: \$15,000,000

**BANK OF AMERICA, N.A., as a Lender**

By: /s/ Brian K. Keeney

Name: Brian K. Keeney

Title: Senior Vice President

Revolving Commitment: \$17,500,000

**MIZUHO CORPORATE BANK, LTD.,  
as a Lender**

By: /s/ Robert Gallagher

Name: Robert Gallagher

Title: Senior Vice President

Revolving Commitment: \$17,500,000

**WACHOVIA BANK, NATIONAL ASSOCIATION, as a  
Lender**

By: /s/ J. Andrew Phelps

Name: J. Andrew Phelps

Title: Vice President

Revolving Commitment: \$12,500,000

**COMERICA BANK, as a Lender**

By: /s/ Gerald R. Finney, Jr.

Name: Gerald R. Finney, Jr.

Title: Vice President

Revolving Commitment: \$10,000,000

**THE NORTHERN TRUST COMPANY,  
as a Lender**

By: /s/ David Sullivan

Name: David Sullivan

Title: Vice President

Revolving Commitment: \$10,000,000

**REGIONS BANK, as a Lender**

By: /s/ Anthony D. Nigro

Name: Anthony D. Nigro

Title: Senior Vice President

Revolving Commitment: \$10,000,000



**JOINDER OF SUBSIDIARY GUARANTORS**

The undersigned, each being a Guarantor under that certain Subsidiary Guarantee Agreement, dated as of December 10, 2004 (the "Guarantee"), in favor of the Administrative Agent, on behalf of the Lenders, hereby acknowledge and consent to, and agree to be bound by, the foregoing modifications and amendments to the Existing Credit Agreement as set forth in this Amendment and to each of the other terms and conditions thereof, and agree that the Guarantee shall continue in full force and effect and binding upon and enforceable against the undersigned in accordance with its terms from and after the date hereof. The undersigned hereby further acknowledge and agree that their obligations under the Guarantee are not subject to any off-set, defense or counterclaim whatsoever and hereby waive any and all defenses of any nature whatsoever, legal, equitable or otherwise, which the undersigned may now have with respect to their obligations under said Guarantee.

Dated as of the 1<sup>st</sup> day of December, 2005.

**ACDOCTOR.COM, INC.**

By: /s/ Ana M. Menendez  
Name: Ana M. Menendez  
Title: Vice President

**AIR SUPPLY DISTRIBUTING LLC**

By: /s/ Ana M. Menendez  
Name: Ana M. Menendez  
Title: Vice President

**AIR SYSTEMS DISTRIBUTORS LLC**

By: /s/ Ana M. Menendez  
Name: Ana M. Menendez  
Title: Vice President

**ATLANTIC SERVICE & SUPPLY LLC**

By: /s/ Ana M. Menendez  
Name: Ana M. Menendez  
Title: Vice President

**BAKER DISTRIBUTING COMPANY LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**COASTLINE DISTRIBUTION LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**COOL HOLDINGS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Treasurer

**COMFORT SUPPLY, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**COMFORT PRODUCTS DISTRIBUTING LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**GEMAIRE DISTRIBUTORS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**HBA DISTRIBUTORS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**HEAT INCORPORATED LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**HEATING & COOLING SUPPLY LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**HOMANS ASSOCIATES LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**THREE STATES SUPPLY COMPANY LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**WSO DISTRIBUTORS, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**DUNHILL STAFFING SYSTEMS, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Treasurer

**DUNHILL PERSONNEL SYSTEM OF NEW JERSEY, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Treasurer

**DUNHILL TEMPORARY SYSTEMS, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Treasurer

**WATSCO HOLDINGS, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**GEMAIRE CARIBE, INC.**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**THE FLORIDA AD COMPANY**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**ATLANTIC JET CHARTER, LLC**

By: Watsco Holdings, Inc., its sole member

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**TCS DISTRIBUTORS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**TRADEWINDS DISTRIBUTING COMPANY, LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**WATSCO INVESTMENTS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**EAST COAST METAL DISTRIBUTORS LLC**

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**TRADEWINDS FLIGHT SERVICES LLC**

By: Watsco Holdings, Inc., its sole member

By: /s/ Ana M. Menendez

Name: Ana M. Menendez

Title: Vice President

**FIRST AMENDMENT  
TO  
SECOND AMENDED AND RESTATED 1996 QUALIFIED  
EMPLOYEE STOCK PURCHASE PLAN**

This First Amendment to the Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan is made and entered into effective as of January 1, 2006, by **WATSCO, INC.**, a Florida corporation (hereinafter called the "Company").

**RECITALS**

**WHEREAS**, the Company established the Second Amended and Restated 1996 Qualified Employee Stock Purchase Plan effective as of July 1, 1996 (the "Plan") to encourage ownership of the Company's Common Stock by eligible employees of the Company, thereby enhancing employee interest in the success and progress of the Company;

**WHEREAS**, pursuant to Section 18 of the Plan, the Compensation Committee may amend the Plan; and

**WHEREAS**, the Compensation Committee now desires to amend the Plan to modify the definition of Purchase Price under the Plan.

**NOW, THEREFORE**, the Plan shall be amended as follows, effective as of January 1, 2006:

1. The definition "Purchase Price" under Section 2 of the Plan hereby is amended to read as follows:

"Purchase Price" – the Fair Market Value of a share of Common Stock on the Purchase Date, less a discount of 5%."

2. Section 6 of the Plan hereby is amended to read as follows:

"On the Purchase Date for each Purchase Period, whole and fractional shares shall be purchased for each Participant with the accumulated Participant payroll deductions and/or with any additional lump-sum amounts contributed by the Eligible Employee. The Purchase Price shall be equal to 95% of the Fair Market Value of a share of Common Stock on the Purchase Date. Additionally, commission charges relating to the purchase of Common Stock under the Plan shall be paid by the Company."

3. Section 12 of the Plan hereby is amended to read as follows:

"As soon as practicable after each Purchase Date, the Custodian shall issue a certificate representing the total number of whole shares of Common Stock for aggregate purchases of all of the Participants hereunder. Any remaining amount, representing a fractional share that may not be certificated shall be carried forward to the next date of exercise for certification as a part of a whole share.

For each Purchase Period ending on or before December 31, 2005, except as hereinafter provided, for a period of 12 months after each Enrollment Date for each such Purchase Period in which the Participant purchases stock (the "Restriction Period"), the shares of Common Stock purchased for that Purchase Period may not be sold, transferred or disposed of by the Participant other than upon death by will or the laws of descent and distribution or to immediate family members or trusts established for their benefit. This restriction shall not apply with respect to shares of Common Stock purchased with respect to any Purchase Period beginning on or after January 1, 2006.

The foregoing restriction shall not apply to the transfer of shares pursuant to a plan of reorganization of the Company, but the stock, securities or other property received in exchange therefore shall also become subject to the same transfer restrictions applicable to the original shares of Common Stock, and shall be held by the Custodian pursuant to the provisions hereof.

Upon expiration of the Restriction Period, the transfer restrictions shall cease to apply and the Participant may direct the sale of some or all of the whole shares of Common Stock in his/her Account that are not then subject to transfer restrictions.”

4. In all other respects, the Plan shall remain unchanged by this Amendment.

**IN WITNESS WHEREOF**, the Company has caused this instrument to be made this 15th day of December 2005.

**COMPANY:**

By: /s/ Barry S. Logan

Barry S. Logan, Senior Vice President

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**WATSCO, INC.**

**SECOND AMENDED AND RESTATED 1996 QUALIFIED  
EMPLOYEE STOCK PURCHASE PLAN**

**OFFERING MEMORANDUM**

**900,000 SHARES**

THIS DOCUMENT CONSTITUTES PART OF A PROSPECTUS  
COVERING SECURITIES THAT HAVE BEEN REGISTERED  
UNDER THE SECURITIES ACT OF 1933

**DECEMBER 15, 2005**



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SECOND AMENDED AND RESTATED 1996 QUALIFIED EMPLOYEE STOCK PURCHASE PLAN

**1. Effective Date and Purpose of the Plan**

The effective date of the Watsco, Inc. 1996 Qualified Employee Stock Purchase Plan (the "Plan") was July 1, 1996. The Plan was amended and restated in 1997 to increase the number of shares available for purchase under the Plan from 600,000 shares to 800,000 shares. The Plan was subsequently amended and restated on April 1, 2005 to increase the number of shares available for purchase under the Plan from 800,000 shares to 900,000 shares, subject to the voting results of the Company's shareholders, and to modify certain other provisions of the Plan. The Plan was further amended, effective as of January 1, 2006, to change the method for determining the purchase price for shares purchased pursuant to the Plan and to modify certain other provisions of the Plan.

The purpose of the Plan is to encourage ownership of Watsco, Inc. Common Stock by eligible employees of the Company, thereby enhancing employee interest in the success and progress of Watsco. The Plan provides the opportunity to invest in such stock at a discounted price through payroll deductions or lump-sum cash contributions. The Plan is intended to comply with Section 423 of the Code.

**2. Definitions**

For purposes of the Plan, the following terms used in this document have the meanings defined below:

"Account" - a separate account maintained by the Custodian for each Participant which reflects the number of shares of Common Stock purchased under the Plan by each Participant.

"Agent, Custodian and Recordkeeper" - Wachovia National Bank.

"Business Day" - a day on which there is trading on the New York Stock Exchange.

"Code" - the Internal Revenue Code of 1986, including any amendments.

"Committee" - the Compensation Committee of the Board of Directors of Watsco.

"Common Stock" - Watsco's \$.50 par value, Common Stock, presently traded on the NYSE.

"Company" - Watsco and any of its subsidiaries (within the meaning of Section 424(f) of the Code) whose employees are designated by the Committee as being Eligible Employees.

"Compensation" - the amount of a Participant's base wages, overtime, commissions and cash bonuses, before giving effect to any reductions made in connection with any plans described in Section 401(k) or Section 125 of the Code.

"Custodian" - Wachovia Bank, N.A. or such other custodial agent as may be appointed by the Committee.

"Eligible Employees" - an employee of the Company who is eligible to participate in the Plan in accordance with Section 3.

"Enrollment Date" - the first Business Day of each Purchase Period.

"Exchange Act" - The Securities Exchange Act of 1934, as amended.

"Fair Market Value" - the value of a share of Common Stock on any Business Day shall be the closing price of the Common Stock as published in the NYSE listing for such day; in the event such prices are not published, the Fair Market Value shall be the most recent published price available.

"NYSE" - the New York Stock Exchange.

“Participant” - each Eligible Employee who has elected to have amounts deducted from his or her Compensation to participate in this Employee Stock Purchase Plan.

“Purchase Date” - the first Business Day after the month end of each Purchase Period on which it is administratively possible to execute the purchase, but no more than five business days after the end of each Purchase Period.

“Purchase Period” - each of the three month periods ending on the last day of March, June, September and December.

“Purchase Price” - the Fair Market Value of a share of Common Stock on the Purchase Date, less a discount of 5%.

“Watsco” - Watsco, Inc., a Florida corporation.

### **3. Eligibility**

Employees are eligible to participate in the Plan if, at the Enrollment Date, the employee has completed 90 days of continuous employment and is regularly scheduled to work at least 20 hours per week and more than 5 months per year. No employee shall be eligible to participate in the Plan if, immediately after the Enrollment Date, the employee (or any other person whose stock would be attributed to the employee pursuant to Section 424(d) of the Code) would own stock and/or options to purchase stock possessing 5% or more of the total combined voting power or value of all classes of stock of Watsco or any parent company or subsidiaries thereof.

### **4. Participation**

Participation in the Plan is voluntary. An eligible employee may elect to participate by completing an enrollment form and returning it to the payroll department of each subsidiary. The payroll deductions will start at the Enrollment Date, subject to the receipt of a completed enrollment form by the payroll department no later than 15 days prior to such Enrollment Date.

Purchase Periods begin on January 1, April 1, July 1 and October 1 of each year. The Committee shall have the power to change the duration of the Purchase Period with respect to any future Purchase Period without shareholder approval if such change is announced at least fifteen (15) days prior to the scheduled beginning of the first Purchase Period to be affected. So long as the Plan remains in effect, once an employee enrolls, he/she will automatically continue participation in subsequent Purchase Periods on the same basis, unless he/she elects to change deduction amounts, withdraws or becomes ineligible.

### **5. Common Stock Available Under the Plan**

The maximum number of shares of Common Stock which may be purchased under the Plan is 900,000, subject to adjustment in the event of any capital change by reason of any stock dividend or split, recapitalization, merger in which Watsco is the surviving entity, combination or exchange of shares or similar corporate change. In such an event, the number and type of shares of Watsco which Participants may purchase under the Plan, and the maximum number of shares which may be purchased under the Plan, will be adjusted, as appropriate, by the Board of Directors described in Section 25.

### **6. Purchases of Common Stock**

On the Purchase Date for each Purchase Period, whole and fractional shares shall be purchased for each Participant with the accumulated Participant payroll deductions and/or with any additional lump-sum amounts contributed by the Eligible Employee. The Purchase Price shall be equal to 95% of the Fair Market Value of a share of Common Stock on the Purchase Date. Additionally, commission charges relating to the purchase of Common Stock under the Plan shall be paid by the Company.

### **7. Investing in the Plan**

There are two methods for investing in the Plan: (1) payroll deductions and (2) lump-sum contributions.

Plan elections for payroll deductions must be made in whole dollar amounts. The minimum dollar amount is \$10.00 per payroll period for employees that are paid weekly and \$20.00 per pay period for employees that are paid either bi-weekly or semi-monthly.

If an employee elects to make a lump-sum contribution, the minimum cash payment is \$100 per Purchase Period. A completed lump-sum contribution form, together with the applicable cash payment, shall be received by the payroll department prior to the Enrollment Date.

## **8. Limitation on Purchases**

The Fair Market Value of Common Stock that a Participant has the right to Purchase under the Plan cannot exceed \$25,000 in one calendar year. This limitation is based on calculating the Fair Market Value at the beginning of each Purchase Period.

## **9. Changing Payroll Deductions; Refunds**

A Participant's elected payroll deduction may be increased or decreased effective with the next Purchase Period. The form must be received by the payroll department no later than 15 days prior to the next Purchase Period. An elected payroll deduction may not be changed during a Purchase Period.

Participants may, however, cease deductions or obtain a refund of his/her lump-sum contribution during a Purchase Period so long as notice is received by the payroll department prior to the Purchase Date. If a Participant ceases deductions during a Purchase Period or wishes the refund of a lump-sum contribution, the deductions already taken or the amount of the lump-sum contribution will be refunded to the Participant as soon as practicable. The Participant would not be eligible to participate again until the Purchase Period after the one in which he/she withdrew. In order to rejoin the Plan, a new enrollment form must be submitted.

## **10. Rights as a Shareholder**

From the initial Purchase Date of shares of Common Stock and thereafter (unless and until the Participant sells the Common Stock), the Participant shall have all the rights and privileges of a stockholder of Watsco with respect to the shares of Common Stock purchased by the Participant. Proxy information will be provided for each stockholders' meeting, so that each Participant may have his/her full and fractional shares voted in accordance with their instructions.

## **11. Accounts**

Wachovia Bank has been appointed Custodian for the Plan. The Custodian will maintain an Account for each Participant. A statement or confirmation will be issued following the purchase of shares of Common Stock, which will include the number of full or fractional shares (rounded to three decimal places) purchased for the Participant at the end of each Purchase Period, the total number of shares owned by the Participant under the Plan and the cost per share.

## **12. Delivery of Share Certificates; Restriction on Transfer**

As soon as practicable after each Purchase Date, the Custodian shall issue a certificate representing the total number of whole shares of Common Stock for aggregate purchases of all of the Participants hereunder. Any remaining amount, representing a fractional share that may not be certificated shall be carried forward to the next date of exercise for certification as a part of a whole share.

For each Purchase Period ending on or before December 31, 2005, except as hereinafter provided, for a period of 12 months after each Enrollment Date for each such Purchase Period in which the Participant purchases stock (the "Restriction Period"), the shares of Common Stock purchased for that Purchase Period may not be sold, transferred or disposed of by the Participant other than upon death by will or the laws of descent and distribution or to immediate family members or trusts established for their benefit. This restriction shall not apply with respect to shares of Common Stock purchased with respect to any Purchase Period beginning on or after January 1, 2006.

The foregoing restriction shall not apply to the transfer of shares pursuant to a plan of reorganization of the Company, but the stock, securities or other property received in exchange therefore shall also become subject to the same transfer restrictions applicable to the original shares of Common Stock, and shall be held by the Custodian pursuant to the provisions hereof.

Upon expiration of the Restriction Period, the transfer restrictions shall cease to apply and the Participant may direct the sale of some or all of the whole shares of Common Stock in his/her Account that are not then subject to transfer restrictions.

## **13. No Transfer Rights**

The rights granted under this Plan may not be assigned or transferred under any circumstances other than by will or the laws of descent and distribution, and are exercisable during a Participant's lifetime only by the Participant.

#### **14. Administration**

The Plan is administered by the Committee. The members of the Committee are not eligible to participate in the Plan. The Committee has the authority to interpret the Plan and to establish rules and regulations for its administration, and the decisions and interpretations by the Committee shall be final, conclusive and binding upon all Participants. The Committee has the authority to delegate the day-to-day administration of the Plan.

#### **15. Designation of Beneficiary**

A Participant may file a written designation of a beneficiary who is to receive any shares and cash in the Participant's Account, as well as any uninvested cash, if any, in the event of such Participant's death. A Participant's beneficiary designation may be changed by the Participant at any time by written notice. In the event of the death of a Participant and in the absence of a beneficiary validly designated under the Plan who is living at the time of such Participant's death, the Company shall deliver such shares and/or cash to the executor of the Participant's estate, or if no such executor or administrator has been appointed (to the knowledge of the Company), the Company, in its discretion, may deliver such shares and/or cash to the spouse or to any one or more dependents or relatives of the Participant, or if no spouse, dependent or relative is known to the Company, then to such other person as the Company may designate.

#### **16. Selling Stock**

Participants may sell shares of Common Stock purchased under the Plan by completing and submitting the appropriate form to the payroll department or by notifying the Custodian. Participants will be responsible for payment of a commission equal to 5 cents per share of Common Stock sold.

Restrictions may apply to the sale of shares of Common Stock by certain officers and executives of the Company and those having similar responsibilities, who are subject to Watsco's Code of Conduct for Senior Executives.

#### **17. Shareholder Approval**

The Plan shall become effective on July 1, 1996, subject to approval by the shareholders of Watsco in accordance with applicable law and the requirements of Section 423 of the Code. Participation in the Plan may commence on the effective date, prior to receipt of shareholder approval, provided that, if shareholder approval is not received, no shares of Common Stock shall be purchased under the Plan until Participants are advised of SEC rules regarding the purchase of shares. Participants would have the option to remain in the Plan or have deducted amounts returned. In addition, to the extent necessary to comply with Rule 16b-3 of the Exchange Act or under Section 423 of the Code or other applicable law, the Committee shall obtain approval of the shareholders of Watsco of any Plan or any Plan amendment in such a manner and to such a degree as required.

#### **18. Amendments**

The Committee may at any time, or from time to time, amend the Plan in any respect, except that, without approval of the shareholders of Watsco, no amendment may be made (a) increasing the number of shares which may be purchased under the Plan (other than provided in Section 5 herein), (b) materially increasing the benefits accruing to Participants, or (c) materially modifying the requirements as to eligibility for participation in the Plan.

#### **19. Termination of the Plan**

The Plan and all rights hereunder shall terminate on the earliest of:

- the date on which the maximum number of shares of Common Stock available for purchase under the Plan has been purchased;
- the termination of the Plan by the Committee;
- the effective date of any consolidation or merger in which Watsco is not the surviving entity, any exchange or conversion of outstanding shares of Watsco for or into securities of another entity or other consideration, or any complete liquidation of Watsco.

Upon termination of the Plan, any full shares in the Participant's account together with a cash amount for any fractional shares shall be delivered by the Custodian to the Participant or his/her legal representative as soon as practicable following such termination.

## **20. Laws and Regulations; Governing Law**

Notwithstanding any other provision of the Plan, the rights of Participants to purchase Common Stock hereunder shall be subject to all applicable Federal, state, and foreign laws, rules and regulations and the rules of each stock exchange upon which the Common Stock is from time to time listed.

As a condition to issuing any shares, the Company may require the Participant to represent and warrant at the time of any such issuance that the shares are being purchased only for investment and without any present intention to sell or distribute such shares if, in the opinion of counsel for the Company, such a representation is required by any of the aforementioned applicable provisions of law.

The Company may make such provisions as it deems appropriate for withholding by the Company pursuant to federal or state tax laws of such amounts as the Company determines it is required to withhold in connection with the purchase or sale by a Participant of any Common Stock acquired pursuant to the Plan. The Company may require a Participant to satisfy any relevant tax requirements before authorizing any issuance of Common Stock to such Participant.

The Plan and purchase of Common Stock hereunder shall be subject to additional rules and regulations, not inconsistent with the Plan, that may be promulgated from time to time by the Committee regarding the purchases and sales of Common Stock.

The validity, construction and effect of the Plan and any rules and regulations relating to the Plan will be determined in accordance with the laws of the State of Florida, without giving effect to principles of conflicts of laws, and applicable Federal law.

## **21. Employment Termination; Participant Retirement; Death**

Disposition of Account Upon Termination of Employment Other Than Retirement or Death-

If the employment of a Participant terminates for any reason other than retirement or death, his/her participation in the Plan terminates automatically as of the date of the termination of employment. The Company shall promptly refund the amount of any uninvested amounts held under the Plan. In addition, upon termination of employment, for Participants with fewer than 100 restricted shares in his/her account, the Custodian, as soon as is practicable following notification, shall sell all whole shares of Common Stock in the Participant's Account and any fractional shares shall also be converted into cash. Such proceeds (less commissions and/or service charges) upon sale of the whole shares together with the cash from the conversion of such fractional shares shall be delivered to the Participant. For participants with 100 shares or greater in his/her Account, the Participant may elect to request that the Custodian issue a share certificate for some or all of such shares in the Account or may request that such shares be sold. Such disposition of shares shall not apply to Participants that are subject to Rule 16b-3 requirements; such participants may obtain certificates for any whole shares held in his/her Account upon notification to the Custodian.

Disposition of Shares Upon Termination by Retirement -

A Participant may, upon attainment of age 65 and retirement from the Company, may by written notice to the Company, request a certificate for any whole shares held in the Account. Unless such a request is received upon notification of retirement, the shares will be subject to sale upon termination of employment as described above.

Disposition of Shares Upon Death-

Upon the death of the Participant, shares will be disposed of in accordance with Section 16.

## **22. Employment**

The Plan shall not confer any rights of continued employment upon any employee of the Company.

## **23. Use of Funds; No Interest Paid**

All funds received by the Company under the Plan shall be included in the general funds of the Company and may be used for any corporate purpose. No interest shall be paid to any Participant or credited to his/her account under the Plan.

#### **24. Additional Restrictions of Rule 16b-3**

Persons subject to Section 16 of the Exchange Act shall comply with the applicable provisions of Rule 16b-3 of the Exchange Act or any successor provision. This Plan shall be deemed to contain such additional conditions and restrictions as may be required by Rule 16b-3 to qualify for the maximum exemption from Section 16 of the Exchange Act with respect to Plan transactions. In the event that Rule 16b-3 provides specific requirements for the administrators of plans of this type, the Plan shall only be administered by such body and in such a manner as to comply with the applicable requirements of Rule 16b-3. Unless permitted by Rule 16b-3, no discretion concerning decisions regarding the Plan shall be afforded to any Committee or person that is not “disinterested” as that term is used in Rule 16b-3.

#### **25. Adjustments Upon Changes in Capitalization**

Subject to any required action by the stockholders of Watsco, the number of shares of Common Stock issued pursuant to the Plan and the number of shares of Common Stock which have been authorized but are unissued under the Plan (collectively, the “Reserves”), as well as the price per share of Common Stock at which such shares may be purchased, shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination, or reclassification of the Common Stock, or any other increase or decrease in the number of shares of Common Stock effected without receipt of consideration by Watsco; provided, however, that conversion of any convertible securities of Watsco shall not be deemed to have been “effected without receipt of consideration.” Such adjustment shall be made by the Committee, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issue by Watsco of shares of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject the Plan.

In the event of the proposed dissolution or liquidation of Watsco, the Purchase Period will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Committee. In the event of a proposed sale of all or substantially all of the assets of Watsco, or the merger of Watsco with or into another corporation, shares under the Plan shall be assumed or an equivalent share shall be assumed or substituted by such successor corporation or a parent or subsidiary of such successor corporation.

The Committee may, if it so determines in the exercise of its sole discretion, also make provision for adjusting the Reserves, as well as the price per share of Common Stock covered by each outstanding option, in the event that Watsco effects one or more reorganizations, recapitalization, rights offerings or other increases or reductions of shares of its outstanding Common Stock, and in the event of Watsco being consolidated with or merged into any other corporation.

#### **26. Federal Income Tax Consequences**

This guide is intended to give you a basic understanding of the United States federal income tax consequences of the Plan. The description is based on the laws and regulations in effect on the date of this Offering Memorandum. The discussion is general in nature and is not intended to be a complete description of the federal income tax consequences of the Plan and is not intended as tax guidance to participants in the Plan. This discussion does not address the effects of other federal taxes or taxes imposed under state, local or foreign tax laws. Because the tax consequences to any participant in the Plan may depend on his or her particular situation, each participant should consult a tax advisor as to the tax consequences of participation.

1. You will not realize any taxable income either at the time you are granted the right to purchase shares under the Plan or at the time the shares are actually purchased. However, amounts deducted from your compensation under the Plan and dividends paid on shares held in your account are taxable as income currently.
2. If you dispose of shares two years or more after the date on which your rights to purchase the shares under the Plan were granted, and one year or more after the date on which the shares were purchased, then you will recognize ordinary income at the time of the disposition in an amount equal to the lesser of (a) the excess of the fair market value of the shares on the date of disposition over the price you paid, or (b) 5% of the value of the shares on the date you were granted the right to purchase the shares. The grant date of your right to purchase shares during a purchase period is generally the first day of that purchase period. However, if you become a participant on a date after the beginning of a purchase period, your grant date is the date you actually became a participant.

In addition, you will recognize a long-term capital gain or loss in an amount equal to the difference between the amount realized upon the sale of the stock and your basis in the stock. Your basis is the purchase price you paid plus any amount taxed to you as ordinary income.

3. If you dispose of shares within two years after the grant date, or within one year of the date on which the shares were purchased, you will recognize ordinary income at that time equal to the excess of the fair market value of the shares on the day they were purchased over the amount you paid for the shares. In addition, you will recognize a capital gain or loss in an amount equal to the difference between the amount realized upon sale of the shares and your basis in the shares. Your basis would be the purchase price you paid plus the amount taxed to you as ordinary compensation income. If you hold the shares for more than one year, the gain or loss will be a long-term capital gain or loss.

4. The Company will not be entitled to a deduction for federal income tax purposes upon either the grant or exercise of purchase rights under the Plan. If you dispose of shares prior to satisfaction of the requisite two-year and one-year holding periods described above, the Company may be entitled to a deduction equal to the ordinary compensation income you would be required to recognize.

## **27. Where You Can Find More Information**

The Company files annual, quarterly and current reports, proxy statements and other information with the SEC under File No. 001-05581. You may read and copy any document in the Company's public files at the SEC's offices at 450 Fifth Street, N.W., Washington, D.C. 20549.

Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. The Company's SEC filings are also available to the public from the SEC's web site at <http://www.sec.gov> through the SEC's electronic data gathering analysis and retrieval system, EDGAR. The Company's common stock is traded on the New York Stock Exchange under the symbol "WSO" and the Company's Class B common stock is traded on the American Stock Exchange under the symbol "WSO-B".

The SEC allows the Company to "incorporate by reference" the information the Company files with it, which means that the Company can disclose important information to you by referring to those documents. The information incorporated by reference is considered to be part of this prospectus. Later information that the Company files with the SEC will automatically update and supersede this information. The Company incorporates by reference the documents listed below and any future filings made with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 by the Company:

- (a) the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004;
- (b) the Company's Current Report on Form 8-K, dated April 4, 2005;
- (c) the Company's Current Report on Form 8-K, dated August 18, 2005;
- (d) the Company's Proxy Statement, dated April 29, 2005, relating to the 2005 Annual Meeting of Shareholders held on May 27, 2005;
- (e) the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005;
- (f) the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005;
- (g) the Company's Quarterly Report on form 10-Q for the quarterly period ended September 30, 2005; and
- (h) the description of the Company's Common Stock set forth in Registrant's Form S-3 Registration Statement under the Securities Act (Registration No. 333-00371).



The Company will provide to you, without charge, a copy of any and all of the documents or information referred to above that the Company has incorporated by reference in this prospectus (other than exhibits to the documents unless those exhibits are specifically incorporated by reference into this prospectus). Requests for those copies should be directed to the following address:

Watsco, Inc.  
2665 South Bayshore Drive  
Suite 901  
Coconut Grove, Florida  
Attn: Martine Donaldson  
Telephone: (305) 714-4100

This offering memorandum forms a prospectus which is part of a registration statement that the Company filed with the SEC. You should rely only on the information incorporated by reference or provided in this prospectus or any supplement. The Company has not authorized anyone else to provide you with different information. You should not assume that the information in this prospectus or any supplement is accurate as of any date other than the date on the front of that document.

**AMENDMENT TO  
THE WATSCO, INC. PROFIT SHARING RETIREMENT PLAN AND TRUST**

**Effective January 1, 2006**, and except as otherwise specified herein, the Watsco, Inc. Profit Sharing Retirement Plan and Trust (hereinafter referred to as the "Plan") is hereby amended as provided herein.

**WHEREAS**, Watsco, Inc. (hereinafter referred to as the "Employer") heretofore adopted the restated Plan effective January 1, 2002; and

**WHEREAS**, the Plan consists of the T. Rowe Price Trust Company 401(k) Prototype Retirement Plan and Trust Agreement (hereinafter referred to as the "Basic Plan Document") and the T. Rowe Price Trust Company 401(k) Retirement Plan Adoption Agreement (hereinafter referred to as the "Adoption Agreement"); and

**WHEREAS**, Section 14.1(b) of the Basic Plan Document provides that the Employer may change the choice of options in the Adoption Agreement at any time; and

**WHEREAS**, the Employer desires to change the options in the Adoption Agreement as provided herein;

**NOW, THEREFORE**, the Plan is hereby amended as follows:

**First Change**

**Section 4.1 of the Adoption Agreement, Participation Requirements, is hereby deleted in its entirety and shall hereafter read as follows:**

**Participation Requirements.** All Employees shall be eligible to participate in this Plan in accordance with the provisions of Article II of the Plan, except the following:

- Employees who have not attained age 21;
- Employees who have not completed 3 months of service;
- Employees included in a unit of Employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining between the Employer and employee representatives. Employee representatives do not include any organization more than half of whose members are Employees who are owners, officers or executives of the Employer;
- Employees who are nonresident aliens and who receive no earned income from the Employer which constitutes income from sources within the United States;
- Leased Employees

**Second Change**

**Section 4.2 of the Adoption Agreement, Entry Dates, shall be hereby deleted in its entirety and shall hereafter read as follows:**

The Entry Dates shall be:

- c)  the first day of each Plan Year and the first day of each month thereafter.

**Third Change**

**Section 5.2 of the Adoption Agreement, Compensation for a Plan Year, is hereby deleted in its entirety and shall hereafter read as follows:**

Compensation for the Plan Year will mean:

- a)  Compensation paid to the Employee by the Employer during the entire Plan Year.

**Fourth Change**

**Section 6.1 of the Adoption Agreement, Elective Deferrals, is hereby deleted in its entirety and shall hereafter read as follows:**

- b)  A Participant may elect to defer an amount up to 100% of his or her Compensation paid during a pay period.

**Fifth Change**

**Section 7.1(c) of the Adoption Agreement, Eligibility for Matching Employer Contributions, is hereby deleted in its entirety and shall hereafter read as follows:**

A Participant shall be eligible to receive a Matching Contribution (whether mandatory or discretionary) for a Plan Year only if:

- his employment with the Employer terminates during the Plan Year by reason of death, retirement on or after Early Retirement Age, if applicable, or Normal Retirement Age, or Total and Permanent Disability; OR
- he completes at least 12 months of service elapsed from the Employee's date of hire; and
- he completes at least 1,000 Hours of Service during the Plan Year; and
- he is employed by the Employer on the last day of the Plan Year

In all other respects, the Plan is hereby ratified and affirmed.

**IN WITNESS WHEREOF**, and as evidence of its adoption of this amendment to the Watsco, Inc. Profit Sharing Retirement Plan and Trust, the Employer has caused this document to be executed by its duly authorized officers.

**Watsco, Inc.**

Witness: \_\_\_\_\_  
Print Name: \_\_\_\_\_

By: /s/ Ana M. Menendez  
Print Name: Ana M. Menendez  
Title: Chief Financial Officer  
Date: January 1, 2006

The Trustees of the Plan hereby acknowledge receipt of the foregoing amendment to the Watsco, Inc. Profit Sharing Retirement Plan and Trust.

**T. Rowe Price Trust Company**

Witness: /s/ Sharon M. Marshall  
Print Name: Sharon M. Marshall

By: /s/ David M. Abbey  
Print Name: David M. Abbey  
Title: Vice President  
Date: February 24, 2006

**SIXTH AMENDMENT  
TO  
EMPLOYMENT AGREEMENT**

This Sixth Amendment to Employment Agreement is made and entered into effective as of January 1, 2006, 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 and January 1, 2005; and

**WHEREAS**, the Compensation Committee of the Company's Board of Directors has determined to increase the Employee's Base Salary from \$850,000 to \$960,000, effective as of January 1, 2006, and has set the targets for the performance based compensation payable by the Company to the Employee for the year 2006; and

**WHEREAS**, the Company and the Employee now desire to amend the 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 2006.

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

1. All capitalized terms in this Sixth 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, 2006, 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 Sixty Thousand (\$960,000) Dollars, payable in bi-weekly or monthly installments."

3. The Employment Agreement is hereby amended by replacing "Exhibit A-1 — 2005 Performance Goals and Performance Based Compensation" with the attached "Exhibit A-1 — 2006 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 Sixth 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

2006 Performance Goals and Performance Based Compensation

IV. Formula

	<b>Performance Based Compensation Formula</b>
<b>A. Earnings Per Share</b>	
For each \$.01 increase	\$ 65,250
<b>B. Increase in Common Stock Price</b>	
(i) If the closing price of a share of Common Stock on 12/31/06 does not exceed \$59.81	\$ 0
(ii) If the closing price of a share of Common Stock on 12/31/06 exceeds \$59.81 but does not equal or exceed \$70.25, for each \$0.01 increase in per share price of a share of Common Stock above \$59.81	\$ 1,200
(iii) If the closing price of a share of Common Stock on 12/31/06 equals or exceeds \$70.25, for each \$0.01 increase in per share price of a share of Common Stock above \$59.81	\$ 1,800

V. Method of Payment

- A. Cash. The Performance Based Compensation determined for 2006 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 2006 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, 2006. 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).

VI. 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, 2006

/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 FINANCIAL DATA**

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

	2005	2004	2003	2002(1)	2001(2)
<b>OPERATIONS</b>					
Revenues	\$ 1,682,724	\$ 1,315,024	\$ 1,232,908	\$ 1,181,136	\$ 1,238,646
Gross profit	423,030	336,935	305,083	287,276	299,040
Operating income	116,458	82,052	61,189	50,924	48,324
Net income	<u>70,019</u>	<u>48,105</u>	<u>34,895</u>	<u>28,536</u>	<u>24,441</u>
<b>SHARE AND PER SHARE DATA</b>					
Diluted earnings per share	\$ 2.52	\$ 1.79	\$ 1.34	\$ 1.07	\$ 0.90
Cash dividends declared and paid per share:					
Common stock	\$ 0.62	\$ 0.38	\$ 0.20	\$ 0.115	\$ 0.10
Class B common stock	0.62	0.38	0.20	0.115	0.10
Weighted average shares outstanding for diluted earnings per share	27,769	26,931	26,037	26,674	27,251
Common stock outstanding	<u>27,463</u>	<u>26,855</u>	<u>26,324</u>	<u>26,032</u>	<u>26,745</u>
<b>BALANCE SHEET INFORMATION</b>					
Total assets	\$ 678,731	\$ 608,289	\$ 535,095	\$ 503,719	\$ 520,820
Long-term obligations	40,189	50,155	60,153	80,233	101,900
Shareholders' equity	<u>450,650</u>	<u>402,738</u>	<u>360,869</u>	<u>329,201</u>	<u>322,420</u>

(1) Effective January 1, 2002, goodwill is no longer being amortized in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets."

(2) 2001 results reflect restructuring charges of \$3,424 (\$2,181 or \$0.08 per share on an after-tax basis).

**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") is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies ("HVAC") in the United States. Watsco has two business segments – the HVAC distribution ("Distribution") segment, which accounted for 99% of 2005 revenues and at December 31, 2005 operated from 352 locations in 31 states, and a temporary staffing and permanent placement services ("Staffing") segment, which accounted for approximately 1% of 2005 revenues.

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 \$3.0 million and \$2.3 million at December 31, 2005 and 2004, respectively, an increase of \$.7 million. The increase from December 31, 2004 is primarily due to the acquisition of East Coast Metal Distributors, Inc. ("East Coast") in the first quarter of 2005 and higher accounts receivable at December 31, 2005 driven by increased sales volume. Accounts receivable balances greater than 90 days past due as a percent of accounts receivable at December 31, 2005 decreased to 1.2% compared to 1.5% at December 31, 2004 and accounts receivable net write-offs as a percent of sales decreased for the year ended December 31, 2005 to .07% compared to .18% for the year ended December 31, 2004. This improved accounts receivable quality primarily reflects tighter credit standards and increased collection activity.



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.

#### Inventory Valuation

Inventories consist of air conditioning, heating and refrigeration equipment and related parts and supplies. In the fourth quarter of 2004, the accounting method for inventory costing was changed to a weighted-average cost basis from a first-in, first-out cost basis. Management believes this change is appropriate given that the majority of our subsidiaries have historically used accounting applications which track and value inventories using the weighted-average cost method. The effect of the adoption of this change did not have a material impact on the stated value of inventory or costs of goods sold in 2004. Prior year balances have not been restated to reflect this change as the impact was not material.

Inventories 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 \$3.1 million and \$2.0 million at December 31, 2005 and 2004, respectively, have been established. The increase in inventory reserves is primarily due to the addition of East Coast and the impact of higher amounts of excess and slow-moving inventory on hand at December 31, 2005 than at December 31, 2004. 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, 2006, 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, 2005 was \$163.7 million, consisting of \$160.1 million attributable to the Distribution segment and \$3.6 million attributable to the Staffing segment. 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 select subsidiaries' health benefit programs. 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, 2005, approximately \$5.2 million of reserves was established related to such insurance programs versus \$3.4 million at December 31, 2004. The increase in the self-insurance reserves reflects the addition of East Coast and the addition of the 2005 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, 2005 and 2004, respectively, 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, 2005, 2004 and 2003:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues	100.0%	100.0%	100.0%
Cost of sales	74.9	74.4	75.3
Gross profit	25.1	25.6	24.7
Selling, general and administrative expenses	18.2	19.4	19.7
Operating income	6.9	6.2	5.0
Interest expense, net	.2	.3	.5
Income taxes	2.5	2.2	1.7
Net income	<u>4.2%</u>	<u>3.7%</u>	<u>2.8%</u>

The following narratives include the results of operations for businesses acquired during 2005, 2004 and 2003. 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 the same geographical market. The results of the Staffing segment are not considered to be material to the results of operations in 2005, 2004 or 2003. See Segment Information in Note 12 to the consolidated financial statements.

### 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, 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.

### **Consolidated Comparison of Year Ended December 31, 2004 with Year Ended December 31, 2003**

Revenues in 2004 increased \$82.1 million, or 7%, as compared to 2003 including a \$35.7 million contribution from locations acquired and opened during 2004 offset by \$11.7 million from closed locations. On a same-store basis, revenues increased \$58.1 million, or 5%, over 2003, benefiting from a strong demand for residential and light-commercial HVAC products, pricing initiatives implemented during the year for certain commodity products and the sale of higher efficiency air conditioning systems, which sell at higher unit prices.

Gross profit in 2004 increased \$31.9 million, or 10%, over 2003, primarily as a result of the aforementioned increase in revenues and improved selling margins. Gross profit margin increased to 25.6% in 2004 from 24.7% in 2003, primarily due to higher markups on certain product offerings as compared to 2003 and higher gross profit margins on certain commodity products that experienced an upward price-movement during 2004.

Selling, general and administrative expenses in 2004 increased \$11.0 million, or 5%, over 2003, reflecting the impact of higher revenues, \$5.4 million of operating costs at locations acquired in 2004 and 2003, \$2.0 million of costs associated with the requirements of Section 404 of the Sarbanes-Oxley Act, offset in part by a \$2.1 million reduction in bad debt expense. The decrease in bad debt expense reflects an overall improvement in the credit quality of the receivable portfolio. See Allowance for Doubtful Accounts section within "Critical Accounting Policies," for further information. As a percentage of revenues, selling, general and administrative expenses decreased to 19.4% in 2004 from 19.7% in 2003 primarily as a result of the effective leveraging of fixed operating costs as compared to 2003.

Interest expense, net decreased \$1.1 million, or 20%, in 2004 primarily due to a 19% decrease in average daily borrowings during the year from the generation of significant cash flows from operations.

The effective tax rate increased to 38.0% in 2004 from 37.3% in 2003. The increase in the effective tax rate in 2004 primarily relates to higher state income tax expense.

### **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 .625% at December 31, 2005 and 2004). A variable commitment fee is paid on the unused portion of the credit line (.15% at December 31, 2005 and 2004). At December 31, 2005 and 2004, \$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 long-term, fixed-rate financing through December 2007 as a complement to the variable rate borrowings available under the revolving credit agreement. \$20.0 million and \$30.0 million, respectively, of Senior Series A Notes (“Notes”) were outstanding at December 31, 2005 and 2004, under the facility bearing interest at 7.07%. The Notes will be repaid in equal installments of \$10.0 million on April 9, 2006 and April 9, 2007. Accordingly, \$10.0 million is classified as “current” in the consolidated balance sheet at December 31, 2005. 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, 2005.

At December 31, 2005 and 2004, 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 \$314.7 million at December 31, 2005 from \$310.5 million at December 31, 2004, primarily due to higher accounts receivable driven by increased sales volume and a buildup of inventory in anticipation of the transition to higher efficiency equipment, offset by the related increase in accounts payable and accrued liabilities. The increase in working capital was primarily funded by operating cash flows.

Net cash provided by operating activities was \$35.8 million in 2005 compared to \$56.7 million in 2004. The decrease was primarily due to the aforementioned increase in accounts receivable and inventory levels partially offset by higher net income in 2005.

Net cash used in investing activities increased to \$54.7 million in 2005 from \$3.3 million in 2004. Net cash used in investing activities increased \$51.4 million from 2004, primarily due to the acquisition of East Coast for cash consideration of \$49.5 million. The acquisition of 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, was completed in January 2005.

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 \$3.4 million.

In April 2003, Watsco subsidiaries completed, in three affiliated transactions, the purchase of certain assets (consisting primarily of accounts receivable, inventories and property and equipment) and the assumption of certain lease obligations of an affiliated group of 52 HVAC distribution locations in Arkansas, Kentucky, Louisiana, Mississippi, Tennessee, Texas and Virginia, funded by cash on hand totaling \$18.4 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, 2005, 2004 and 2003.

Net cash used in financing activities of \$38.5 million in 2005 was primarily used for stock repurchases, cash dividends paid and repayment of Notes, partially offset by 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 347,600 shares at a cost of \$17.7 million in 2005, 29,900 shares at a cost of \$.8 million in 2004 and 442,900 shares at a cost of \$6.7 million in 2003. In aggregate, 5.8 million shares of Common stock and Class B common stock have been repurchased at a cost of \$84.9 million since the inception of the program. The remaining 1.7 million shares authorized for repurchase are subject to certain restrictions included in the debt agreements. Subsequent to December 31, 2005 through the date of this filing, we repurchased 53,300 shares at a cost of \$3.7 million.

Cash dividends of 62 cents, 38 cents and 20 cents per share of Common stock and Class B common stock were paid in 2005, 2004 and 2003, respectively. In October 2005, Watsco's Board of Directors approved an increase in the quarterly cash dividend to 20 cents per share from 14 cents per share of Common and Class B common stock. 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, 2005, we had \$27.7 million of cash and cash equivalents, \$65.1 million of additional borrowing capacity under the revolving credit agreement and \$105.0 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 solid 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

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. The acquisition was funded by cash on hand of approximately \$.7 million.

In March 2006, one of our subsidiaries completed the acquisition of a food service distributor with locations in Birmingham and Montgomery, Alabama, funded by cash on hand of approximately \$1.0 million.

#### Contractual Obligations and Off-Balance Sheet Arrangements

The following table summarizes our significant contractual obligations as of December 31, 2005 (in millions):

Contractual Obligations	Payments due by Period						Total
	2006	2007	2008	2009	2010	Thereafter	
Non-cancelable operating lease obligations	\$36.3	\$31.7	\$25.3	\$19.6	\$12.9	\$ 22.3	\$148.1
Non-cancelable purchase orders (1)	32.2	—	—	—	—	—	32.2
Long-term debt	10.0	10.0	—	—	—	—	20.0
Minimum royalty payments	1.0	1.0	1.0	1.0	1.0	1.0	6.0
Other debt	0.1	0.1	0.1	—	—	—	0.3
Total Contractual Obligations	<u>\$79.6</u>	<u>\$42.8</u>	<u>\$26.4</u>	<u>\$20.6</u>	<u>\$13.9</u>	<u>\$ 23.3</u>	<u>\$206.6</u>

(1) Cancelable purchase orders for the purchase of inventory and other goods and services are not included in our estimates above. We are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as purchase orders may represent authorization to purchase rather than binding agreements. Our cancelable purchase orders are based on our current distribution needs and are fulfilled by our vendors within short time horizons. The non-cancelable purchase orders were placed with our key equipment suppliers in preparation of the government mandated transition to manufacture higher efficiency equipment to ensure adequate product availability and are not expected to exceed demand requirements.

Commercial obligations outstanding at December 31, 2005 under the revolving credit agreement consist of borrowings totaling \$30.0 million, standby letters of credit totaling \$4.3 million and commercial letters of credit totaling \$.6 million. Borrowings under the revolving credit agreement at December 31, 2005 had revolving maturities of 90 days and letters of credit have varying terms expiring through January 2007.

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, 2005. 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 Statement of Financial Accounting Standards (“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, 2005 and 2004, 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 2005, 2004 or 2003 for hedge ineffectiveness. The negative fair value of the derivative financial instrument was \$.9 million and \$2.5 million at December 31, 2005 and 2004, respectively, and is included, net of accrued interest, in deferred income taxes and other liabilities in the consolidated balance sheets.

At December 31, 2005, 2004 and 2003, \$.5 million, net of deferred tax benefits of \$.3 million, \$1.3 million net of deferred tax benefits of \$.8 million and \$2.2 million net of deferred tax benefits of \$1.3 million was recorded in OCL associated with cash flow hedges. During 2005, 2004 and 2003, we recognized decreases in unrealized losses in OCL relating to cash flow hedges of \$.9 million, net of income tax expense of \$.5 million, \$.8 million, net of income tax expense of \$.4 million and \$1.3 million, net of income tax expense of \$.8 million, respectively.

The change in OCL during 2005, 2004 and 2003, reflected the reclassification of \$.6 million, net of income tax benefit of \$.3 million, \$.9 million, net of income tax benefit of \$.6 million and \$1.3 million, net of income tax benefit of \$.8 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, 2005, approximately \$.4 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 (4.81% at December 31, 2005).

At December 31, 2005 and 2004, 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, 2005 and 2004, 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 February 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140.” SFAS No. 155 improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, the Statement allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after January 1, 2007, with earlier adoption permitted as of January 1, 2006, provided that financial statements for any interim period of that fiscal year have not yet been issued. We do not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3.” This Statement replaces Accounting Principles Board (“APB”) Opinion No. 20, “Accounting Changes,” and SFAS No. 3, “Reporting Accounting Changes in Interim Financial Statements,” and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions will continue to be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Earlier application is permitted for accounting changes and corrections of errors made occurring in fiscal years beginning after June 1, 2005. We do not expect the adoption of SFAS No. 154 to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29.” This Statement addresses the measurement of exchanges of nonmonetary assets. The guidance in APB Opinion No. 29, “Accounting for Nonmonetary Transactions,” is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective January 1, 2006 and is not expected to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123(R), “Share-Based Payment,” which replaces SFAS No. 123 and supercedes APB Opinion No. 25 and amends SFAS No. 95, “Statement of Cash Flows.” The new standard will require companies to recognize compensation cost for stock options and other stock-based awards based on their fair value as measured on the grant date. The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. In April 2005, the Securities and Exchange Commission announced that the accounting provisions of SFAS No. 123(R) are to be applied in the first quarter of the fiscal year beginning after June 15, 2005. As a result, we adopted SFAS No. 123(R) on January 1, 2006 and will recognize stock-based compensation expense using the modified prospective method. The impact of the adoption of SFAS No. 123(R) depends on levels of share-based payments granted in the future. However, had we adopted SFAS No. 123(R) in prior periods, the impact of SFAS No. 123(R) would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share. See Note 1, “Summary of Significant Accounting Policies — Stock-Based Compensation” to the consolidated financial statements for the pro forma net income and earnings per share amounts as if we had used a fair-value based method. We estimate that the impact of adopting the provisions of SFAS No. 123(R) will approximate a \$.04 to \$.05 reduction in earnings per diluted share for the year ending December 31, 2006 based on the current level, vesting schedules and historical forfeiture rates of stock options outstanding.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs,” an amendment of Accounting Research Bulletin No. 43, Chapter 4, “Inventory Pricing.” SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is effective January 1, 2006 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 expectations and are subject to a number of risks and uncertainties, 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, 2005 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 14, 2005, 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, 2005.



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**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, 2005. 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, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 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 sheet of Watsco, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of income, shareholders' equity and cash flows for the year then ended. 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 financial position of Watsco, Inc. and subsidiaries as of December 31, 2005, and the consolidated results of their operations and their cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

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, 2005, 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 15, 2006 expressed an unqualified opinion thereon.

/s/ GRANT THORNTON LLP

Miami, Florida  
March 15, 2006

**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 sheet of Watsco, Inc. and subsidiaries as of December 31, 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the two years in the period 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 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Watsco, Inc. and subsidiaries as of December 31, 2004, and the consolidated results of their operations and their cash flows for each of the two years in the period 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, 2005, 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, 2005, 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, 2005, 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 sheet of Watsco, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended and our report dated March 15, 2006 expressed an unqualified opinion on those consolidated financial statements.

/s/ GRANT THORNTON LLP

Miami, Florida  
March 15, 2006

**WATSCO, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

<i>(In thousands, except per share data)</i>	<i>Years Ended December 31,</i>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues	\$ 1,682,724	\$ 1,315,024	\$ 1,232,908
Cost of sales	1,259,694	978,089	927,825
Gross profit	423,030	336,935	305,083
Selling, general and administrative expenses	306,572	254,883	243,894
Operating income	116,458	82,052	61,189
Interest expense, net	3,342	4,413	5,509
Income before income taxes	113,116	77,639	55,680
Income taxes	43,097	29,534	20,785
Net income	<u>\$ 70,019</u>	<u>\$ 48,105</u>	<u>\$ 34,895</u>
Earnings per share for Common and Class B common stock:			
Basic	\$ 2.69	\$ 1.89	\$ 1.39
Diluted	<u>\$ 2.52</u>	<u>\$ 1.79</u>	<u>\$ 1.34</u>
Weighted average Common and Class B common shares and equivalent shares used to calculate earnings per share:			
Basic	26,049	25,507	25,086
Diluted	<u>27,769</u>	<u>26,931</u>	<u>26,037</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>	<i>December 31,</i>	
	2005	2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 27,650	\$ 85,144
Accounts receivable, net	191,747	145,213
Inventories	266,543	218,704
Other current assets	8,051	8,638
Total current assets	<u>493,991</u>	<u>457,699</u>
Property and equipment, net	17,244	15,093
Goodwill and intangibles, net	163,686	132,165
Other assets	3,810	3,332
	<u>\$678,731</u>	<u>\$608,289</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term obligations	\$ 10,079	\$ 10,056
Accounts payable	100,829	94,704
Accrued expenses and other current liabilities	68,390	42,399
Total current liabilities	<u>179,298</u>	<u>147,159</u>
Long-term obligations:		
Borrowings under revolving credit agreement	30,000	30,000
Long-term notes, net of current portion	10,000	20,000
Other long-term obligations, net of current portion	189	155
Total long-term obligations	<u>40,189</u>	<u>50,155</u>
Deferred income taxes and other liabilities	8,594	8,237
Commitments and contingencies (Notes 10 and 11)		
Shareholders' equity:		
Common stock, \$0.50 par value, 60,000,000 shares authorized in 2005 and 2004 and 29,860,948 and 28,586,407 shares issued in 2005 and 2004, respectively	14,931	14,293
Class B common stock, \$0.50 par value, 10,000,000 shares authorized in 2005 and 2004 and 3,392,497 and 3,712,059 shares issued in 2005 and 2004, respectively	1,696	1,857
Paid-in capital	264,903	238,627
Deferred compensation on restricted stock	(35,894)	(20,943)
Accumulated other comprehensive loss, net of tax	(478)	(1,268)
Retained earnings	290,383	237,342
Treasury stock, at cost, 5,790,613 and 5,443,013 shares of Common and Class B common stock in 2005 and 2004, respectively	(84,891)	(67,170)
Total shareholders' equity	<u>450,650</u>	<u>402,738</u>
	<u>\$678,731</u>	<u>\$608,289</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		Paid-In Capital	Deferred Compensation on Restricted Stock	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Total
	Shares	Amount						
<b>Balance at December 31, 2002</b>	26,031,752	\$15,501	\$216,124	\$ (9,067)	\$ (3,399)	\$169,649	\$(59,607)	\$329,201
Net income						34,895		34,895
Changes in unrealized gains and losses on available-for-sale securities and derivative instruments, net of income taxes					1,324			1,324
Comprehensive income								36,219
Retirement of common stock	(100,314)	(50)	(1,806)					(1,856)
Common stock contribution to 401(k) plan	36,900	18	820					838
Stock issuances from exercise of stock options and employee stock purchase plan	593,607	297	5,298					5,595
Tax benefit from stock-based compensation			1,884					1,884
Issuances of restricted shares of common stock	237,152	119	4,454	(4,573)				—
Forfeitures of restricted shares of common stock	(32,500)	(16)	(411)	427				—
Amortization of unearned compensation				919				919
Cash dividends declared on Common and Class B common stock, \$0.20 per share						(5,204)		(5,204)
Purchase of treasury stock	(442,900)						(6,727)	(6,727)
<b>Balance at December 31, 2003</b>	<b>26,323,697</b>	<b>15,869</b>	<b>226,363</b>	<b>(12,294)</b>	<b>(2,075)</b>	<b>199,340</b>	<b>(66,334)</b>	<b>360,869</b>
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 restricted shares of common stock	150,000	75	4,214	(4,289)				—
Forfeitures of restricted shares of common stock	(80,000)	(40)	(967)	1,007				—
Restricted 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)
<b>Balance at December 31, 2004</b>	<b>26,855,453</b>	<b>16,150</b>	<b>238,627</b>	<b>(20,943)</b>	<b>(1,268)</b>	<b>237,342</b>	<b>(67,170)</b>	<b>402,738</b>
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 restricted shares of common stock	314,552	157	11,377	(5,165)				6,369
Forfeitures of restricted shares of common stock	(5,000)	(2)	(63)	65				—
Common stock issued for acquisition	145,536	73	4,427					4,500
Restricted 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)
<b>Balance at December 31, 2005</b>	<b>27,462,832</b>	<b>\$16,627</b>	<b>\$264,903</b>	<b>\$ (35,894)</b>	<b>\$ (478)</b>	<b>\$290,383</b>	<b>\$(84,891)</b>	<b>\$450,650</b>

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>	<i>Years Ended December 31,</i>		
	2005	2004	2003
<b>Cash flows from operating activities:</b>			
Net income	\$ 70,019	\$ 48,105	\$ 34,895
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Depreciation and amortization	6,189	6,768	6,499
Amortization of unearned compensation	2,528	1,002	919
Provision for doubtful accounts	1,854	1,556	3,628
(Gain) loss on sale of property and equipment	(1,460)	214	74
Net gain on sale of available-for-sale securities	(106)	—	—
Deferred income tax provision	197	3,883	1,817
Non-cash contribution for 401(k) plan	1,181	922	838
Tax benefit from stock-based compensation	7,654	2,746	1,884
<b>Changes in operating assets and liabilities, net of effects of acquisitions:</b>			
Accounts receivable	(26,000)	(7,855)	(6,472)
Inventories	(33,271)	(23,412)	(9,554)
Accounts payable and other liabilities	4,716	19,579	19,172
Other, net	2,281	3,231	6,552
<b>Net cash provided by operating activities</b>	<b>35,782</b>	<b>56,739</b>	<b>60,252</b>
<b>Cash flows from investing activities:</b>			
Business acquisitions, net of cash acquired	(49,481)	(3,403)	(18,424)
Capital expenditures	(7,283)	(4,846)	(3,069)
Purchase of minority interest in consolidated subsidiary	—	—	(1,294)
Proceeds from sale of available-for-sale securities	160	—	—
Proceeds from sale of property and equipment	1,876	4,946	278
<b>Net cash used in investing activities</b>	<b>(54,728)</b>	<b>(3,303)</b>	<b>(22,509)</b>
<b>Cash flows from financing activities:</b>			
Purchase of treasury stock	(17,721)	(836)	(6,727)
Common and Class B common stock dividends	(16,978)	(10,103)	(5,204)
Repayment of long-term notes	(10,000)	—	—
Repayment under revolving credit agreement	—	(30,000)	(20,000)
Proceeds from revolving credit agreement	—	30,000	—
Payment of debt acquisition costs	—	(346)	—
Net proceeds from (repayments of) other long-term obligations	57	(114)	(180)
Net proceeds from issuances of common stock	6,094	6,768	4,827
<b>Net cash used in financing activities</b>	<b>(38,548)</b>	<b>(4,631)</b>	<b>(27,284)</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(57,494)</b>	<b>48,805</b>	<b>10,459</b>
Cash and cash equivalents at beginning of year	85,144	36,339	25,880
<b>Cash and cash equivalents at end of year</b>	<b>\$ 27,650</b>	<b>\$ 85,144</b>	<b>\$ 36,339</b>

*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. Watsco has two business segments – the HVAC distribution ("Distribution") segment, which accounted for 99% of 2005 consolidated revenues and operated from 352 locations in 31 states at December 31, 2005 and a temporary staffing and permanent placement services ("Staffing") segment, which accounted for 1% of 2005 consolidated revenues.

**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.

**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, 2005 and 2004 included \$45 and \$11,500, respectively, of municipal securities with put options of 35 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, 2005 and 2004, the allowance for doubtful accounts totaled \$3,019 and \$2,271, 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. In the fourth quarter of 2004, the accounting method for inventory costing was changed to a weighted-average cost basis from a first-in, first-out cost basis. Management believes this change is appropriate given that the majority of our subsidiaries have historically used accounting applications which track and value inventories using the weighted-average cost method. The effect of the adoption of this change did not have a material impact on the stated value of inventory or costs of goods sold in 2004. Prior year balances have not been restated to reflect this change as the impact was not material.

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, 2005 and 2004, inventory reserves totaled \$3,142 and \$2,035, 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, 2005 and 2004, we have \$4,866 and \$3,785, 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 \$173 at December 31, 2004 are included in other current 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, 2004, \$76 of unrealized gains, net of deferred taxes of \$45, 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 1-40 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 \$6,064, \$6,765 and \$6,499 for the years ended December 31, 2005, 2004 and 2003, 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 Statement of Financial Accounting Standards ("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 \$125, \$3 and \$0 for the years ended December 31, 2005, 2004 and 2003, respectively. Based on the current amount of intangible assets with finite lives, we estimate amortization expense to be approximately \$50 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, 2005, 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 and service fee revenue from the Staffing segment. 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 \$5,975, \$4,477 and \$4,847 for the years ended December 31, 2005, 2004 and 2003, 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 \$6,827, \$5,553 and \$5,348 for the years ended December 31, 2005, 2004 and 2003, respectively.

## Stock-Based Compensation

The intrinsic value-based method of accounting prescribed by Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations, is applied in accounting for stock options under fixed plans. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, “Accounting for Stock-Based Compensation,” as amended by SFAS No. 148, “Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123,” established preferred accounting and mandatory disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, we elected to continue to apply the intrinsic value-based method of accounting described above and have adopted the disclosure requirements of SFAS No. 123 and SFAS No. 148.

The weighted-average fair value at date of grant for stock options granted during 2005, 2004 and 2003 was \$11.70, \$8.82 and \$8.78, respectively, and was estimated using the Black-Scholes option valuation model based on the following weighted-average assumptions:

<i>Years Ended December 31,</i>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Expected life in years	4.0	4.8	6.3
Risk-free interest rate	4.1%	3.4%	4.3%
Expected volatility	34.0%	36.9%	58.2%
Dividend yield	1.38%	1.33%	1.14%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including expected stock price volatility. The stock-based compensation arrangements have characteristics significantly different from those of traded options, and changes in the subjective input assumptions used in valuation models can materially affect the fair value estimate.

Had compensation cost for the stock-based compensation plans been determined based on the fair value method at the grant dates for awards under the stock option plans consistent with the method of SFAS No. 123, pro forma net income and earnings per share would be as follows:

<i>Years Ended December 31,</i>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income, as reported	\$70,019	\$48,105	\$34,895
Stock-based compensation expense included in net income, net of tax	1,567	621	576
Stock-based compensation expense determined under the fair value-based method, net of tax	(3,247)	(2,258)	(2,690)
Net income, pro forma	<u>\$68,339</u>	<u>\$46,468</u>	<u>\$32,781</u>
Basic earnings per share for Common and Class B common stock:			
As reported	\$ 2.69	\$ 1.89	\$ 1.39
Pro forma	\$ 2.62	\$ 1.82	\$ 1.31
Diluted earnings per share for Common and Class B common stock:			
As reported	\$ 2.52	\$ 1.79	\$ 1.34
Pro forma	\$ 2.46	\$ 1.73	\$ 1.26

In December 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 123(R), “Share-Based Payment,” which requires all companies to measure compensation cost for all share-based payments, including employee stock options, at fair value. Watsco adopted this statement beginning with the first quarter of 2006. We are required to recognize compensation on all share-based grants made on or after January 1, 2006, and for the unvested portion of share-based grants made prior to January 1, 2006.

## 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 for both federal and state income tax purposes 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, including any vested restricted shares. Shares included in the basic calculation of earnings per share only include outstanding Common and Class B common stock, as there were no vested restricted shares outstanding. 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 unvested shares of restricted 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:

<i>Years Ended December 31,</i>	2005	2004	2003
Net income available to shareholders	\$70,019	\$48,105	\$34,895
Allocation of net income for Basic:			
Common stock	\$61,030	\$41,195	\$30,020
Class B common stock	8,989	6,910	4,875
	<u>\$70,019</u>	<u>\$48,105</u>	<u>\$34,895</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 restricted shares, calculated using the treasury method, as included in the calculation of diluted weighted-average shares:

<i>Years Ended December 31,</i>	2005	2004	2003
Weighted-average Common and Class B common shares outstanding for basic earnings per share	26,049,365	25,506,950	25,086,321
Weighted-average Common shares outstanding for basic earnings per share	22,705,131	21,843,155	21,581,738
Diluted shares resulting from:			
Stock options	1,145,174	1,005,511	658,678
Restricted shares of common stock	574,298	418,848	292,326
Effect of assuming conversion of Class B common shares into Common stock	3,344,234	3,663,795	3,504,583
Shares for diluted earnings per share	<u>27,768,837</u>	<u>26,931,309</u>	<u>26,037,325</u>

Diluted earnings per share excluded 81,000, 41,500 and 159,313 shares for the years ended December 31, 2005, 2004 and 2003, 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, 60,000, 145,000 and 10,000 shares for the years ended December 31, 2005, 2004 and 2003, respectively, related to restricted 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 to the consolidated financial statements. The components of comprehensive income are as follows:

<i>Years Ended December 31,</i>	2005	2004	2003
Net income	\$70,019	\$48,105	\$34,895
Changes in unrealized losses on derivative instrument, net of income tax expense of \$(534), \$(449) and \$(772), respectively	866	832	1,296
Changes in unrealized (losses) gains on available-for-sale securities arising during the period, net of income tax benefit (expense) of \$5, \$14 and \$(17), respectively	(10)	(25)	28
Less: reclassification adjustment for net securities gains realized in net income, net of income tax expense of \$40, \$0 and \$0, respectively	(66)	—	—
<b>Comprehensive income</b>	<b>\$70,809</b>	<b>\$48,912</b>	<b>\$36,219</b>

#### Recently Issued Accounting Standards

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140." SFAS No. 155 improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, the Statement allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after January 1, 2007, with earlier adoption permitted as of January 1, 2006, provided that financial statements for any interim period of that fiscal year have not yet been issued. We do not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3." This Statement replaces APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions will continue to be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made after January 1, 2006. We do not expect the adoption of SFAS No. 154 to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29." This Statement addresses the measurement of exchanges of nonmonetary assets. The guidance in APB Opinion No. 29, "Accounting for Nonmonetary Transactions," is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective January 1, 2006 and is not expected to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which replaces SFAS No. 123 and supercedes APB No. 25 and amends SFAS No. 95, "Statement of Cash Flows." The new standard will require companies to recognize compensation cost for stock options and other stock-based awards based on their fair value as measured on the grant date. The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. In April 2005, the Securities and Exchange Commission announced that the accounting provisions of SFAS No. 123(R) are to be applied in the first quarter of the fiscal year beginning after June 15, 2005. As a result, we adopted SFAS No. 123(R) on January 1, 2006 and will recognize stock-based compensation expense using the modified prospective method. The impact of the adoption of SFAS No. 123(R) depends on levels of share-based payments granted in the future. However, had we adopted SFAS No. 123(R) in prior periods, the impact of SFAS No. 123(R) would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share. See Note 1, "Stock-Based Compensation," for the pro forma net income and earnings per share amounts as if we had used a fair-value based method. We estimate that the impact of adopting the provisions of SFAS No. 123(R) will approximate a

\$.04 to \$.05 reduction in earnings per diluted share for the year ending December 31, 2006 based on the current level, vesting schedules and historical forfeiture rates of stock options outstanding. See Note 6 for additional information related to our stock-based compensation and benefit plans.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs," an amendment of Accounting Research Bulletin No. 43, Chapter 4 "Inventory Pricing." SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is effective January 1, 2006 and is not expected to have a material impact on our consolidated financial statements.

#### Recently Adopted Accounting Standard

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations—an interpretation of SFAS No. 143." This Interpretation provides clarification with respect to the timing of liability recognition for legal obligations associated with the retirement of tangible long-lived assets when the timing and/or method of settlement of the obligation are conditional on a future event. We adopted this Interpretation during the fourth quarter of 2005 and it did not have an impact on our consolidated financial statements.

#### Reclassifications

Certain reclassifications of prior year amounts have been made to conform to the 2005 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 48%, 45% and 44% of all purchases made in 2005, 2004 and 2003, respectively, with the largest supplier accounting for 17%, 17% and 15% of all purchases made in 2005, 2004 and 2003, respectively. 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>2005</u>	<u>2004</u>
Land	\$ 654	\$ 654
Buildings and improvements	16,233	14,715
Machinery, vehicles and equipment	23,842	25,498
Furniture and fixtures	18,437	19,272
	<u>59,166</u>	<u>60,139</u>
Less: accumulated depreciation and amortization	(41,922)	(45,046)
	<u>\$ 17,244</u>	<u>\$ 15,093</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 .625% at December 31, 2005 and 2004). A variable commitment fee is paid on the unused portion of the credit line (.15% at December 31, 2005 and 2004). At December 31, 2005 and 2004, \$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 long-term, fixed-rate financing through December 2007 as a complement to the variable rate borrowings available under the revolving credit agreement. \$20,000 and \$30,000, respectively, of Senior Series A Notes ("Notes") were outstanding at December 31, 2005 and 2004 under the facility bearing interest at 7.07%. The Notes will be repaid in equal installments of \$10,000 on April 9, 2006 and April 9, 2007. Accordingly, \$10,000 is classified as "current" in the consolidated balance sheet at December 31, 2005. 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, 2005.

## Other Long-Term Obligations

Other long-term obligations, net of current portion, of \$189 and \$155 at December 31, 2005 and 2004, 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 2009. Annual maturities of other long-term obligations for the years subsequent to December 31, 2005 are \$79 in 2006, \$81 in 2007, \$69 in 2008 and \$39 in 2009.

Total cash payments for interest were \$4,854, \$4,870 and \$6,090 for the years ended December 31, 2005, 2004 and 2003, respectively.

## 5. Income Taxes

The components of income tax expense are as follows:

<u>Years Ended December 31,</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Federal	\$39,439	\$27,146	\$20,464
State	3,658	2,388	321
	<u>\$43,097</u>	<u>\$29,534</u>	<u>\$20,785</u>
Current	\$42,900	\$25,651	\$18,968
Deferred	197	3,883	1,817
	<u>\$43,097</u>	<u>\$29,534</u>	<u>\$20,785</u>

Following is a reconciliation of the effective income tax rate:

<u>Years Ended December 31,</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Federal statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit and other	3.1	2.9	2.6
Change in valuation allowance	—	.1	(.3)
	<u>38.1%</u>	<u>38.0%</u>	<u>37.3%</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>2005</u>	<u>2004</u>
Current deferred tax assets:		
Accounts receivable reserves	\$ 1,060	\$ 755
Capitalized inventory costs and inventory reserves	1,564	654
Other current deferred tax assets	825	930
Total current deferred tax assets (1)	<u>3,449</u>	<u>2,339</u>
Long-term deferred tax assets (liabilities):		
Deductible goodwill	(14,006)	(11,193)
Net operating loss carryforwards	1,505	2,491
Unrealized loss on derivative instrument	294	829
Depreciation	472	(358)
Other long-term net deferred tax assets	4,510	2,803
Total net long-term deferred tax liabilities	<u>(7,225)</u>	<u>(5,428)</u>
Less valuation allowance	(396)	(396)
Net deferred tax liabilities	<u>\$ (4,172)</u>	<u>\$ (3,485)</u>

(1) Current deferred tax assets of \$3,449 and \$2,339 have been included in the consolidated balance sheets in other current assets at December 31, 2005 and 2004, 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 \$396 of valuation allowance at December 31, 2005 is necessary to reduce the deferred tax assets to the amount that will more likely than not be realized. There is no change in the valuation allowance for the current year. At December 31, 2005, there were state net operating loss carryforwards of \$29,521, which expire in varying amounts from 2006 through 2026. These amounts are available to offset future taxable income. There were no federal net operating loss carryforwards at December 31, 2005.

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 \$31,298, \$22,487 and \$14,169 for the years ended December 31, 2005, 2004 and 2003, respectively.

## 6. Stock-Based Compensation and Benefit Plans

### 2001 Incentive Compensation Plan

In June 2001, Watsco's shareholders approved the 2001 Incentive Compensation Plan (the "2001 Plan"). The 2001 Plan is administered by the Compensation Committee (the "Committee") of the Board of Directors. 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, 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 restricted 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 1,252,859 shares of Common stock, net of cancellations and 838,496 shares of Class B common stock, net of cancellations have been awarded under the 2001 Plan as of December 31, 2005. There were 908,645 shares of common stock reserved for future grants as of December 31, 2005 under the 2001 Plan. There are 1,026,825 options of common stock outstanding under the 2001 Plan at December 31, 2005.

The 2001 Plan provides for acceleration of exercisability of the options upon the occurrence of certain events relating to a change of control, merger, sale of assets or liquidation of Watsco. Additionally, the Committee or Board of Directors may impose on any award or the exercise thereof, at the date of grant or thereafter, such additional terms and conditions not inconsistent with the provisions of the 2001 Plan, as the Committee or the Board of Directors shall determine, including terms requiring forfeiture of awards in the event of termination of employment by the participant and terms permitting a participant to make elections relating to his or her award. The Committee or the Board of Directors retains full power and discretion to accelerate, waive or modify, at any time, any term or condition of an award that is not mandatory under the 2001 Plan. Options under the 2001 Plan are for terms of five to ten years and are exercisable as determined by the Committee.

### 1991 Stock Option Plan

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 1,562,538 of common stock are outstanding under the 1991 Plan at December 31, 2005. Options under the 1991 Plan are for a term of ten years and are exercisable as determined by the Committee. During 2005 and 2004, 115,614 shares of Common stock with an aggregate market value of \$5,812 and 7,836 shares of Common stock with an aggregate market value of \$236, respectively, were delivered as payment for stock option exercises. These shares were then retired. Under the 1991 Plan, the Committee may waive the vesting period and permit options to be exercised immediately.

On December 28, 2005, the Compensation Committee of the Board of Directors approved the vesting acceleration of 76,616 stock options for certain 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. 123(R). At the date of the modification, we believe that it is probable that the awards subject to the aforementioned acceleration will vest under their original terms as 92% of the awards would have otherwise vested during 2006. If the original service conditions of the awards are not achieved, compensation expense will be recorded.

A summary of option activity for the 2001 Plan and 1991 Plan is shown below:

	2005		2004		2003	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	2,894,788	\$ 14.04	3,342,426	\$ 12.99	3,714,113	\$ 12.13
Granted	295,500	39.61	228,250	27.46	384,500	16.21
Exercised	(509,959)	10.74	(445,338)	12.65	(509,475)	8.71
Forfeited	(90,966)	22.93	(230,550)	14.95	(246,712)	13.88
Outstanding at end of year	<u>2,589,363</u>	<u>\$ 17.30</u>	<u>2,894,788</u>	<u>\$ 14.04</u>	<u>3,342,426</u>	<u>\$ 12.99</u>
Options exercisable at end of year	<u>2,074,146</u>	<u>\$ 13.94</u>	<u>2,271,872</u>	<u>\$ 13.08</u>	<u>2,451,527</u>	<u>\$ 12.99</u>



The following table summarizes our options outstanding and our options exercisable as of December 31, 2005:

Range of Exercise Prices	Outstanding			Exercisable	
	Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Life	Options Exercisable	Weighted-Average Exercise Price
\$ 8.38-\$15.00	1,095,025	\$ 11.38	4.5	1,042,675	\$ 11.31
\$15.01-\$30.00	1,211,338	17.43	3.3	1,018,138	16.38
\$30.01-\$50.00	264,000	38.37	4.2	13,333	34.15
\$50.01-\$63.96	19,000	57.41	4.9	—	—
	<u>2,589,363</u>	<u>\$ 17.30</u>	<u>3.9</u>	<u>2,074,146</u>	<u>\$ 13.94</u>

#### Restricted Stock Awards

During 2005, 2004 and 2003, 336,315, 334,552 and 237,152 shares of restricted common stock, respectively, were granted under the 2001 Plan, which are subject to certain restrictions. Restrictions lapse upon attainment of retirement age or under other circumstances. The weighted-average fair value at the date of grant for restricted stock granted in 2005, 2004 and 2003 was \$52.17, \$31.86 and \$19.28, respectively. During 2005, 2004 and 2003, 5,000, 80,000 and 32,500 shares, respectively, were forfeited. The unearned compensation resulting from the grant of restricted shares is reported as a reduction of shareholders' equity in the consolidated balance sheets and is being amortized to earnings over the period from date of issuance to the date of restriction lapse. Total amortization expense related to the restricted shares amounted to \$2,528, \$1,002 and \$919 for the years ended December 31, 2005, 2004 and 2003, respectively. At December 31, 2005, we recorded an accrued liability and deferred compensation of \$12,379 associated with an obligation to issue 206,315 shares of restricted Class B common stock under an executive compensation agreement. In February 2006, we issued these restricted shares of Class B common stock.

#### 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 2005, 2004 and 2003 employees purchased 76,632, 54,076 and 81,768 shares of Common stock at an average price of \$31.51, \$20.75 and \$13.55 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 3,335, 3,361 and 2,364 for the years ended December 31, 2005, 2004 and 2003, respectively. At December 31, 2005, 66,719 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, 2005, 2004 and 2003, the aggregate contribution required to the plan was \$1,181, \$922 and \$838, respectively. This contribution is made during the first quarter of the subsequent year.

### 7. Acquisitions

In January 2005, Watsco acquired East Coast Metal Distributors, Inc. ("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 \$49,481, net of cash acquired, and the issuance of 145,536 shares of unregistered Common stock having a fair value of \$4,500. In accordance with SFAS No. 141, "Business Combinations," we applied the purchase method of accounting to record this transaction. The purchase price allocation for the acquisition is as follows:

Accounts receivable	\$ 22,388
Inventories	14,568
Other current assets	561
Property and equipment	1,348
Goodwill	27,083
Intangible – trade name	4,413
Intangible – non-compete agreements	149
Other assets	675
Accounts payable and accrued expenses	(17,204)
Fair value of common stock issued	(4,500)
Cash used in acquisition, net of cash acquired	<u>\$ 49,481</u>

Excess purchase cost recorded in connection with the acquisition of East Coast 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. Goodwill of \$1,602 recorded as a result of these acquisitions is expected to be deductible for tax purposes.

In April 2003, three Watsco subsidiaries completed the acquisition of certain assets (consisting primarily of accounts receivable, inventories and property and equipment) and the assumption of certain lease obligations of an affiliated group of 52 HVAC distribution locations in Arkansas, Kentucky, Louisiana, Mississippi, Tennessee, Texas and Virginia, funded by cash on hand totaling \$18,424. In connection with this acquisition, Watsco recorded \$4,876 of goodwill, all of which is expected to be deductible for tax purposes.

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, 2005, 2004 and 2003.

## 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 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, 2006, 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, 2005 was \$163,686, consisting of \$160,117 attributable to the Distribution segment and \$3,569 attributable to the Staffing segment. 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, 2003	\$ 130,412
Acquired goodwill	1,602
Purchase price adjustments, net	(185)
Balance at December 31, 2004	131,829
Acquired goodwill	27,083
Balance at December 31, 2005	<u>\$ 158,912</u>

Intangible assets, net, consist of:

<u>December 31,</u>	<u>2005</u>	<u>2004</u>
<b>Unamortizable intangible assets:</b>		
Trade name	\$ 4,413	\$ 10
Other	—	44
	<u>4,413</u>	<u>54</u>
<b>Amortizable intangible assets:</b>		
Customer relationships	210	210
Non-compete agreements	224	75
Less: accumulated amortization	(73)	(3)
	<u>361</u>	<u>282</u>
	<u>\$ 4,774</u>	<u>\$ 336</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. 347,600 shares were repurchased at a cost of \$17,721 in 2005, 29,900 shares at a cost of \$836 in 2004 and 442,900 shares at a cost of \$6,727 in 2003. In aggregate since the inception of the repurchase plan in 1999, 5,790,613 shares of Common stock and Class B common stock were repurchased at a cost of \$84,891. The remaining 1,709,387 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, 2005 and 2004, 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, 2005 and 2004, 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 2005, 2004 or 2003. The negative fair value of the derivative financial instrument was \$927 and \$2,471 at December 31, 2005 and 2004, respectively, and is included, net of accrued interest, in deferred income taxes and other liabilities in the consolidated balance sheets.

At December 31, 2005, 2004 and 2003, \$478, net of deferred tax benefits of \$294, \$1,344 net of deferred tax benefits of \$829 and \$2,176 net of deferred tax benefits of \$1,278 was recorded in OCL associated with the cash flow hedge. During 2005, 2004 and 2003, we recognized decreases in unrealized losses in OCL relating to cash flow hedges of \$866, net of income tax expense of \$534, \$832, net of income tax expense of \$449 and \$1,296, net of income tax expense of \$772, respectively.

The change in OCL during 2005, 2004 and 2003, reflected the reclassification of \$555, net of income tax benefit of \$342, \$905, net of income tax benefit of \$556 and \$1,296, net of income tax benefit of \$772, 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, 2005, approximately \$430 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 (4.81% at December 31, 2005).

### Off-Balance Sheet Financial Instruments

At December 31, 2005 and 2004, we were contingently liable under standby letters of credit aggregating \$4,346 and \$4,938, 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 select subsidiaries' health benefit programs. 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. At December 31, 2005, \$5,203 of reserves was established related to such insurance programs versus \$3,413 at December 31, 2004.

### Variable Interest Entities

In conjunction with our casualty insurance programs, limited equity interests are held in two captive insurance entities. 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 \$3,100, a majority of which is collateralized under standby letters of credits issued on the insurance entities' behalf. 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, 2005, 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 ("Whirlpool") to make minimum annual royalty payments of \$1,000 through 2011. In April 2005, Whirlpool and Watsco amended the licensing agreement, whereby if certain revenue targets are not met in 2005 or 2006, either party may terminate the licensing agreement.

### Operating Leases

At December 31, 2005, 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 \$36,315 in 2006, \$31,721 in 2007, \$25,348 in 2008, \$19,534 in 2009, \$12,937 in 2010 and \$22,331 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, 2005, 2004 and 2003 was \$34,360, \$27,835 and \$28,806, respectively.

### Purchase Commitments

At December 31, 2005, we were obligated under non-cancelable purchase orders for the purchase of inventory from our vendors in the amount of \$32,196. Such purchase orders were placed in the ordinary course of business.

## 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. There are two reportable segments: the distribution of HVAC equipment and related parts and supplies - which comprises 99%, 98% and 98% of revenues in 2005, 2004 and 2003, respectively, and a personnel staffing services business. The Distribution segment has similar products, customers, marketing strategies and operations. The operating segments are managed separately because each offers distinct products and services.

The reporting segments follow 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. During 2004, we changed our methodology for accounting for inter-segment services provided by the Staffing segment to the Distribution segment as if the services were provided to third parties, at current market prices. Accordingly, revenues and operating income in the segments below reflect these intersegment service charges. Prior year information has been restated to reflect this change. 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>	2005	2004	2003
<b>Revenues:</b>			
Distribution	\$1,658,249	\$1,294,715	\$1,206,526
Staffing	25,292	21,251	27,219
Elimination of intersegment Staffing revenues	(817)	(942)	(837)
<b>Revenues from external customers</b>	<b>\$1,682,724</b>	<b>\$1,315,024</b>	<b>\$1,232,908</b>
<b>Operating income (loss):</b>			
Distribution	\$ 134,577	\$ 100,818	\$ 75,297
Staffing	(10)	(1,100)	(709)
Corporate expenses	(18,109)	(17,666)	(13,399)
	<u>\$ 116,458</u>	<u>\$ 82,052</u>	<u>\$ 61,189</u>
<b>Depreciation and amortization:</b>			
Distribution	\$ 5,737	\$ 5,029	\$ 5,809
Staffing	119	155	259
Corporate	333	1,584	431
	<u>\$ 6,189</u>	<u>\$ 6,768</u>	<u>\$ 6,499</u>
<b>Assets:</b>			
Distribution	\$ 619,998	\$ 499,771	\$ 475,942
Staffing	7,235	8,861	10,081
Corporate	51,498	99,657	49,072
	<u>\$ 678,731</u>	<u>\$ 608,289</u>	<u>\$ 535,095</u>
<b>Capital expenditures:</b>			
Distribution	\$ 7,104	\$ 4,118	\$ 2,709
Staffing	56	157	58
Corporate	123	571	302
	<u>\$ 7,283</u>	<u>\$ 4,846</u>	<u>\$ 3,069</u>

### 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 2005, 2004 and 2003, this firm was paid \$172, \$89 and \$123, respectively, for services performed.

At December 31, 2002, Watsco and a then member of the Board of Directors had a 75% and 25% equity interest, respectively, in Atlantic Jet Charter LLC ("Atlantic Jet"), a company which provides aircraft services to Watsco, a former member of the Board of Directors and his affiliates. During 2003, Atlantic Jet recovered \$66 in costs from the Board member pertaining to his and his affiliates' usage of the aircraft. In February 2003, the 25% equity interest was purchased for total cash consideration of \$1,294.

**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
<b>Year Ended December 31, 2005</b>					
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	<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>
<b>Year Ended December 31, 2004</b>					
Revenues (1)	\$ 278,715	\$ 372,636	\$ 357,366	\$ 306,307	\$ 1,315,024
Gross profit	71,447	96,098	92,531	76,859	336,935
Net income	<u>\$ 6,629</u>	<u>\$ 19,387</u>	<u>\$ 15,898</u>	<u>\$ 6,191</u>	<u>\$ 48,105</u>
Earnings per share for Common and Class B common stock (2)					
Basic	\$ 0.26	\$ 0.76	\$ 0.62	\$ 0.24	\$ 1.89
Diluted	<u>\$ 0.25</u>	<u>\$ 0.72</u>	<u>\$ 0.59</u>	<u>\$ 0.23</u>	<u>\$ 1.79</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, 2005 and 2004. At February 28, 2006, excluding shareholders with stock in street name, there were 375 Common stock shareholders of record and 163 Class B common stock shareholders of record.

	Common		Class B		Cash Dividends	
	High	Low	High	Low	Common	Class B
<b>Year Ended December 31, 2005:</b>						
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>
<b>Year Ended December 31, 2004:</b>						
Fourth quarter	\$35.22	\$28.00	\$34.51	\$28.10	\$ .10	\$ .10
Third quarter	30.38	26.59	30.20	26.50	.10	.10
Second quarter	30.45	25.59	30.00	25.40	.10	.10
First quarter	<u>29.35</u>	<u>22.43</u>	<u>29.39</u>	<u>23.00</u>	<u>.08</u>	<u>.08</u>

## REGISTRANT'S SUBSIDIARIES

The following table sets forth, at February 28, 2006, 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
WSO Distributors, Inc.	Nevada
Staffing:	
Dunhill Personnel Systems of New Jersey, Inc.	New Jersey
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 15, 2006, with respect to the consolidated financial statements of Watsco, Inc. and subsidiaries, 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 2005 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 15, 2006

**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 as of December 31, 2004, and for each of the two years in the period ended December 31, 2004, included in the 2005 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 as of December 31, 2004, and for each of the two years in the period ended December 31, 2004, incorporated herein by reference, and our report with respect to the financial statement schedule of Watsco, Inc. and subsidiaries for each of the two years in the period 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  
March 13, 2006

## 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;
  - d) 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
  - e) 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 16, 2006

/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 16, 2006

/s/ Barry S. Logan

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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 16, 2006

/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, 2005, 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 16, 2006

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, 2005, 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 16, 2006

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, 2005, 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 16, 2006

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.