

ARGYLE SECURITY, INC.  
Form 10-Q  
May 20, 2008

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended March 31, 2008.

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to.

Commission File Number: 000-51639

**Argyle Security, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**20-3101079**  
(I.R.S. Employer  
Identification No.)

**200 Concord Plaza Suite 700 San Antonio, TX 78216**

(Address of Principal Executive Offices including Zip Code)

**(210) 828-1700**

(Registrant's Telephone Number, Including Area Code)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

There were 5,964,342 shares of the Registrant's common stock issued and outstanding as of May 20, 2008.

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Argyle Security, Inc. Index to Form 10-Q

<b><u>Part I.</u></b>	<b><u>Financial Information</u></b>	1
	<u>Item 1. Consolidated Financial Statements (unaudited)</u>	1
	<u>Consolidated Balance Sheets</u>	1
	<u>Consolidated Statements of Operations</u>	2
	<u>Consolidated Statement of Stockholders' Equity</u>	3
	<u>Consolidated Statement of Cash Flows</u>	4
	<u>Notes to Unaudited Consolidated Financial Statements</u>	5
	<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
	<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	49
	<u>Item 4. Controls and Procedures</u>	49
<b><u>Part II.</u></b>	<b><u>Other Information</u></b>	
	<u>Item 1. Legal Proceedings</u>	50
	<u>Item 1A. Risk Factors</u>	50
	<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	50
	<u>Item 3. Defaults Upon Senior Securities</u>	50
	<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	50
	<u>Item 5. Other Information</u>	50
	<u>Item 6. Exhibits</u>	51

SIGNATURES

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## PART I - FINANCIAL INFORMATION

## ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## ARGYLE SECURITY, INC.

## CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands except share data)

	March 31, 2008 (Unaudited)	December 31, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 2,532	\$ 3,556
Receivables:		
Contract net of allowance for doubtful accounts of \$ 1,164 and \$975 at March 31, 2008 and December 31, 2007, respectively	34,843	14,459
Contract receivables related party	10,204	10,887
Other receivables related party	48	42
Costs and estimated earnings in excess of billings on incomplete contracts	5,739	7,665
Intangible assets	3,650	2,959
Refundable income taxes	491	561
Other current assets	1,433	378
Deferred income taxes, net	191	
Total current assets	59,131	40,507
Property and equipment, net	6,717	5,227
Goodwill	24,336	19,937
Intangible assets	18,136	15,146
Deposits, deferred transaction costs, and other assets	547	331
Total other assets	49,736	40,641
Total assets	\$ 108,867	\$ 81,148
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 21,207	\$ 14,318
Accounts payable related party	53	40
Billings in excess of costs and estimated earnings on incomplete contracts	10,105	5,733
Notes and interest payable to stockholders	24	40
Current portion of capitalized lease obligations	107	97
Current portion of long-term debt	413	81
Deferred income taxes		210
Total current liabilities	31,909	20,519
Long-Term Liabilities:		
Deferred income taxes	6,063	6,095
Long-term debt less current portion	32,518	15,965

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Deferred rent and other long term liabilities	18	
Long-term capitalized lease obligations - less current portion	1,871	1,904
Total long-term liabilities	40,470	23,964
Total liabilities	72,379	44,484
<b>Stockholders' Equity</b>		
Preferred stock of Argyle Security, Inc. - \$.0001 par value; 1,000,000 shares authorized; 0 shares issued and outstanding		
Common stock of Argyle Security, Inc. - \$.0001 par value; 89,000,000 shares authorized; shares issued and outstanding 5,964,342 at March 31, 2008 and 5,879,342 at December 31, 2007	1	1
Additional paid in capital	36,837	36,279
Accumulated earnings (deficit)	(350)	384
Total stockholders' equity	36,488	36,664
Total liabilities and stockholders' equity	\$ 108,867	\$ 81,148

See notes to unaudited consolidated financial statements

## ARGYLE SECURITY, INC.

## CONSOLIDATED STATEMENT OF OPERATIONS

(unaudited)

(in thousands except share data)

	Three Months Ended		Predecessor (ISI)
	March 31,	March , 31	Three Months Ended
	2008	2007	March 31,
			2007
<b>Revenues:</b>			
Contract revenues	\$ 25,188	\$	\$ 9,341
Contract revenues - related party	6,943		5,801
Service and other revenues	5,466		3,710
Total revenues	37,597		18,852
<b>Cost of revenues:</b>			
Contract costs	25,670		12,056
Service and other costs, including \$1,252 of amortization of intangibles in 2008	5,523		3,041
Total cost of revenues	31,193		15,097
Gross profit	6,404		3,755
<b>Operating expenses:</b>			
Salaries and related expenses, including \$558 in stock-based compensation	3,369		1,462
Consulting fees and outside services	945	165	92
Depreciation	459	1	241
Other general and administrative expenses	1,588	125	760
Amortization of intangible assets	421		
Total operating expenses	6,782	291	2,555
Operating income (loss)	(378)	(291)	1,200
<b>Other income (expense):</b>			
Interest income	26	385	4
Interest expense	(799)	(15)	(984)
Total other income (expense)	(773)	370	(980)
Income (loss) before provision for income taxes	(1,151)	79	220
Provision (benefit) for income taxes	(417)	27	97
Net income (loss)	(734)	52	123
Deferred interest, net of taxes, attributable to common stock subject to possible redemption		50	
Net income (loss) allocable to holders of non-redeemable common stock	\$ (734)	\$ 2	
<b>Weighted-average number of shares of common stock outstanding:</b>			
Basic	5,749,342	4,781,307	
Diluted	5,749,342	4,781,307	
<b>Net income (loss) per share:</b>			
Basic	\$ (0.13)	\$ 0.01	
Diluted	\$ (0.13)	\$ 0.01	
<b>Weighted-average number of shares of common stock outstanding exclusive of shares subject to possible redemption:</b>			
Basic	5,749,342	4,016,680	
Diluted	5,749,342	4,016,680	

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Net income (loss) per share exclusive of common stock and related  
deferred interest subject to possible redemption:

Basic	\$	(0.13)	\$	0.00
Diluted	\$	(0.13)	\$	0.00

See notes to unaudited consolidated financial statements

ARGYLE SECURITY, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

DECEMBER 31, 2007 THROUGH MARCH 31, 2008

(unaudited)

(in thousands except per share data)

	Common Stock			Additional		Accumulated		Total	
	Shares	Amount		Paid in		Earnings /		Stockholders	
				Capital		(Deficit)		Equity	
Balance at December 31, 2007	5,879,342	\$	1	\$	36,279	\$	384	\$	36,664
Stock-based compensation	85,000				558				558
Net income (loss)						(734)			(734)
Balance at March 31, 2008	5,964,342	\$	1	\$	36,837	\$	(350)	\$	36,488

See notes to unaudited consolidated financial statements



## ARGYLE SECURITY, INC.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(unaudited)

(in thousands)

	Three Months Ended		Predecessor (ISI)
	March 31,	March 31,	Three Months Ended
	2008	2007	March 31,
			2007
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ (734)	\$ 52	\$ 123
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities			
Stock-based compensation	558		
Amortization	1,673		
Depreciation	488	1	328
Interest earned on assets held in trust		(381)	
Tax payments relapsed from the trust		119	
Decrease (increase) in contract receivables	(15,552)		(1,052)
Decrease (increase) in related party contract receivables	684		
Decrease (increase) in related party receivables	(6)		
Decrease (increase) in costs and estimated earnings in excess of billings	2,702		53
Decrease (increase) in other assets	237	(66)	(146)
Increase (decrease) in accounts payable and accrued expenses	3,569	(145)	(1,033)
Increase (decrease) in other long-term liabilities	18		
Increase (decrease) in deferred income taxes	(392)	22	63
Increase (decrease) in billings in excess of costs and estimated earnings	3,854		262
<b>Net cash used in operating activities</b>	<b>\$ (2,901)</b>	<b>\$ (398)</b>	<b>\$ (1,402)</b>
<b>Cash flows from investing activities:</b>			
Purchase of investments held in trust		(70,375)	
Maturity of investments held in trust		70,375	
Acquisitions, net of cash acquired	(5,259)		(73)
Purchase of property and equipment	(781)		(534)
Transaction costs	(223)	(160)	(44)
Increase / (decrease) in other assets		(6)	
<b>Net cash used in investing activities</b>	<b>\$ (6,263)</b>	<b>\$ (166)</b>	<b>\$ (651)</b>
<b>Cash flows from financing activities:</b>			
Offering costs	(7)	(7)	
Payments on borrowings	(12,071)		(20)
Proceeds from borrowings	15,136		1,801
Proceeds from notes payable	5,105		
Payments on capital lease obligations	(23)		(25)
<b>Net cash provided by (used in) financing activities</b>	<b>\$ 8,140</b>	<b>\$ (7)</b>	<b>\$ 1,756</b>
<b>Net decrease in cash and cash equivalents</b>	<b>\$ (1,024)</b>	<b>\$ (571)</b>	<b>\$ (297)</b>
Cash and cash equivalents at beginning of year	3,556	694	359
<b>Cash and cash equivalents at end of year</b>	<b>\$ 2,532</b>	<b>\$ 123</b>	<b>\$ 62</b>

See notes to unaudited consolidated financial statements

**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 1 Basis of Presentation**

Argyle Security, Inc. is the parent company whose primary business operations are conducted under the name Argyle Security USA (which consists of the business of our wholly-owned subsidiary ISI Security Group, Inc. and all of its operating subsidiaries). We refer to Argyle Security USA as AUSA in this document and where the context indicates, to the historical business of ISI Security Group, Inc. as ISI.

Argyle Security, Inc. (formerly Argyle Security Acquisition Corporation) (the Company, we, us, our, or Argyle) was incorporated in Delaware in June 2005 as a blank check company formed to acquire, through merger, capital stock exchange, asset acquisition, or other similar business combination, a business in the security industry. On July 31, 2007, Argyle consummated its initial acquisition through the acquisition of 100% of the outstanding capital stock of ISI Detention Contracting Group, Inc. (ISI) and its subsidiaries. Prior to the acquisition of ISI, Argyle had no operations and was considered a developmental stage enterprise. ISI is deemed to be a predecessor to the Company. As a result, the statements of operations and statements of cash flows of ISI for three months ended March 31, 2007 are presented for comparative purposes. The results of operations and cash flows on a consolidated basis subsequent to the acquisition of ISI are not comparative to the predecessor ISI results of operations and cash flows because the basis for the acquired assets and liabilities of ISI have been adjusted to fair value pursuant to Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*.

In February 2008, we reorganized our business under the name of Argyle Security USA, or AUSA, through which we provide physical security solutions to commercial, governmental, and correctional customers. Argyle Security USA has two reporting segments, Argyle Corrections and Argyle Commercial Security.

Argyle Corrections consists of all of our businesses in the corrections sector including ISI, Metroplex Control Systems (MCS) as well as Com-Tec Security LLC (Com-Tec) and Peterson Detention, Inc. (PDI). Com-Tec and PDI were acquired in January 2008. This segment includes:

- ISI (also referred to historically as ISI-Detention) designs, engineers, supplies, installs, and maintains a full array of detention systems and equipment, targeting correctional facilities throughout the United States;
- Metroplex Control Systems (also referred to historically as MCS-Detention) designs, engineers, supplies, installs and maintains complex, customized security, access control, video and electronic security control system solutions at correctional and government facilities;

- PDI is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories; and
- Com-Tec is an industry leader in the custom design and manufacture of electronic security and communications systems.

Argyle Commercial Security focuses on the commercial security sector and provides turnkey, electronic security systems to the commercial market. Currently, MCS Commercial Fire & Security is the only member of this group and is referred to historically as MCS-Commercial.

AUSA is a detention and commercial equipment contractor that specializes in turnkey installations, including design, engineering, supply, and installation of various detention equipment for correctional facilities and institutions. The work is performed under fixed-price contracts. The projects are located in various cities in the United States. The length of the contracts varies but is typically less than two years. AUSA also provides turnkey installations covering the full spectrum of electronic security and low voltage systems, including fire alarm, access control, closed circuit television, intercom, sound/paging, and other custom designed systems.

On January 1, 2008, MCFSA, Ltd. (MCFSA), all of the partnership interests of which are directly or indirectly wholly owned by AUSA, acquired substantially all of the business assets and liabilities of Fire Quest Inc. (Fire Quest). Fire Quest is engaged in the business of alarm system sales and service.

**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 1 Basis of Presentation (continued)**

On January 4, 2008, AUSA acquired substantially all of the business assets and liabilities of PDI. PDI is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories.

On January 31, 2008, ISI Controls, Ltd. (ISI-Controls), a wholly owned subsidiary of AUSA, which in turn is a wholly owned subsidiary of the Company, closed a transaction, pursuant to which ISI-Controls acquired 100% of the outstanding units of Com-Tec, resulting in Com-Tec becoming a wholly owned subsidiary of ISI-Controls. Com-Tec is engaged in the business of custom design, manufacture and installation of electronic security and communication systems.

The unaudited consolidated financial statements of Argyle as of March 31, 2008 and for the three months ended March 31, 2008 and 2007 include the accounts of the Company and all wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results to be expected for a full fiscal year.

*Pro Forma Results of Operations*

The accompanying unaudited consolidated statements of operations only reflect the operating results of companies acquired following the date of acquisition and do not reflect the operating results prior to the acquisitions. Following are pro forma unaudited results of operations for the Company for the three months ended March 31, 2008 and 2007 assuming the Fire Quest, PDI and Com-Tec acquisitions occurred on January 1, 2008 and 2007, respectively.

The Company derived the unaudited pro forma results of operations from (i) the unaudited consolidated financial statements of ISI from January 1, 2007 to March 31, 2007, (ii) the unaudited consolidated financial statements of Com-Tec for the one month ended January 31, 2008 and the three months ended March 31, 2007, (iii) the unaudited financial statements of PDI for the three months ended March 31, 2007, (iv) the unaudited financial statements of Fire Quest for the three months ended March 31, 2007 and (v) the unaudited consolidated financial statements of the Company for the three months ended March 31, 2008 and 2007. The unaudited pro forma results of operations are not necessarily indicative of results of operations that may have actually occurred had the acquisitions taken place on the dates noted, or the future financial position or operating results of the Company. The pro forma adjustments are based upon available information and assumptions that the Company believes are reasonable. The pro forma adjustments include adjustments for interest expense and increased depreciation and amortization expense as a result of the application of the purchase method of accounting based on the fair values of the tangible and intangible assets.



## ARGYLE SECURITY, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2008

## Note 1 Basis of Presentation (continued)

Pro Forma Consolidated Statements of Operations  
(unaudited)

(in thousands, except share data)

	Three Months Ended	
	March, 31 2008	March 31, 2007
<b>Revenues:</b>		
Contract revenues	\$ 26,906	\$ 11,806
Contract revenues - related party	6,943	5,801
Service and other revenues	5,466	5,566
<b>Total revenues</b>	<b>39,315</b>	<b>23,173</b>
<b>Cost of revenues:</b>		
Contract costs	27,040	13,813
Service and other costs, including amortization of intangibles (\$1,289 for 2008 and 2007)	5,559	5,620
<b>Total cost of revenues</b>	<b>32,599</b>	<b>19,433</b>
<b>Gross profit</b>	<b>6,716</b>	<b>3,740</b>
<b>Operating expenses:</b>		
Salaries and related expense, including \$558 stock-based compensation in 2008	3,577	2,489
Consulting fees and outside services	948	295
Depreciation	462	302
Other general and administrative expenses	1,668	1,165
Amortization of intangible assets	442	442
<b>Total operating expenses</b>	<b>7,097</b>	<b>4,693</b>
<b>Operating loss</b>	<b>(381)</b>	<b>(953)</b>
<b>Other income (expense):</b>		
Interest income	26	59
Interest expense	(844)	(754)
<b>Total other income (expense)</b>	<b>(818)</b>	<b>(695)</b>
<b>Loss before provision for income taxes</b>	<b>(1,199)</b>	<b>(1,648)</b>
Provision (benefit) for income taxes	(451)	(691)
<b>Net income (loss)</b>	<b>\$ (748)</b>	<b>\$ (957)</b>
<b>Weighted-average number of shares outstanding:</b>		
Basic	5,749,342	5,749,342
Diluted	5,749,342	5,749,342
<b>Net loss per share:</b>		
Basic	\$ (0.13)	\$ (0.17)
Diluted	\$ (0.13)	\$ (0.17)





**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 2 Background, Formation, and Summary of Significant Accounting Policies**

Argyle completed a private placement (the Private Placement) in January 2006 and received net proceeds of approximately \$0.9 million. Also in January 2006, the registration statement for Argyle's initial public offering (Public Offering) was declared effective, and the net proceeds from the sale of Argyle's units, after deducting certain offering expenses of approximately \$2.4 million, including underwriting discounts of approximately \$1.8 million, were approximately \$28.2 million. Approximately \$27.3 million of the proceeds from the Public Offering and the Private Placement were placed in a trust account for Argyle's benefit. Except for \$0.6 million in interest that was earned on the funds contained in the trust account and that was released to Argyle to be used as working capital, and the amounts released to Argyle for the payment of taxes, Argyle was not able to access the amounts held in the trust until it consummated a business combination. The amounts held outside of the trust account were used by Argyle to provide for business, legal, and accounting due diligence on prospective acquisitions and continuing general and administrative expenses. Prior to releasing the funds held in trust, the trust account contained \$1.4 million reserved for the compensation of Argyle's underwriters in its Public Offering which was paid to them upon completion of the business combination. All amounts held in trust were released at July 31, 2007 to fund the ISI acquisition.

On March 14, 2007, the underwriters from Argyle's Public Offering agreed to forfeit any and all rights or claims to a pro-rata portion of the deferred underwriting costs and associated interest with respect to any shares of common stock redeemed in connection with any acquisition (see Note 16). In connection with the Public Offering and the Private Placement, Argyle's officers and directors placed all the shares owned by them before the Private Placement and the Public Offering into an escrow account. Except in certain circumstances, the shares held in escrow may not be released prior to January 24, 2009.

As part of the ISI merger, public stockholders holding 211,965 of the aggregate number of shares sold in the Public Offering elected to redeem such shares (see Note 14). The per share redemption price was equal to \$7.80 per share including interest earned thereon in the trust account, net of taxes payable, \$0.6 million of interest income which was released from the trust account in September 2006 to fund our working capital, and amounts owed to the underwriter for the Private Placement (approximately \$45,000 plus interest). Approximately \$1.7 million was paid to redemptive shareholders in August of 2007.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents, and the carrying amounts approximate fair value.

***Contracts Receivable***

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Contracts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is established as losses are estimated to have occurred through a provision for bad debts charged to earnings. Losses are charged against the allowance when management believes the uncollectibility of a receivable is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for doubtful accounts is evaluated on a regular basis by management and is based on historical experience and specifically identified questionable receivables. The evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

***Revenue Recognition***

A majority of the Company's revenues are performed under fixed-price construction contracts. Revenues under fixed-price contracts are recognized under the percentage-of-completion methodology. Service revenues are recognized when the services have been delivered to and accepted by the customer. Other revenues consists of product sales and are recognized upon shipment, or later if required by shipping terms, provided title is transferred, prices are fixed and collection is deemed probable.

***Construction Contracts***

Construction contracts are those as defined in the American Institute of Certified Public Accountants' Statement of Position 81-1 (SOP 81-1), *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

Most of the Company's contracts extend over a period of 12 to 16 months, which is the period the Company considers to be its operating cycle. Such contracts generally provide that the customers accept completion of progress to date and compensate the Company for services rendered measured in terms of units installed, hours expended, or some other measure of progress. Revenues from construction contracts are recognized on the percentage-of-completion method in accordance with SOP 81-1. The Company recognizes revenue on signed contracts and change orders. The Company generally recognizes revenue on unsigned change orders where it has written notices to proceed from the customer and where collection is deemed probable. Percentage-of-completion for construction contracts is measured principally by the percentage of costs incurred and accrued to date for each contract to the estimated total costs for each contract at completion. The Company generally considers contracts to be substantially complete upon departure from the work site and acceptance by the customer. Contract costs include all direct material, labor, subcontract, equipment costs, related payroll taxes and insurance costs, and any other indirect costs related to contract performance. Changes in job performance, job conditions, estimated contract costs, profitability, and final contract settlements may result in revisions to costs and income and the effects of these revisions are recognized in the period in which the revisions are determined. Provisions for total estimated losses on incomplete contracts are made in the period in which such losses are determined.

Pre-contract costs are costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained. Such costs are expensed as incurred.

The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the customer. Based on the Company's experience with similar contracts in recent years, the retention balance at

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each balance sheet date will be collected within the subsequent fiscal year.

The current asset, costs and estimated earnings in excess of billings on incomplete contracts, represents revenues recognized in excess of amounts billed which management believes will be billed and collected within the subsequent year. The current liability, billings in excess of costs and estimated earnings on incomplete contracts, represents billings in excess of revenues recognized.

**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

*Service Sales*

Service sale revenue are recognized when the services have been delivered to and accepted by the customer. These are generally short-term projects which are evidenced by signed service agreements or customer work orders or purchase orders. These sales agreements/customer orders generally provide for billing to customers based on time at quoted hourly or project rates plus costs of materials and supplies furnished by the Company.

*Inventory*

Inventory is valued at the lower of cost or market and consists primarily of finished goods. Costs of finished goods are determined using the average cost method for all segments of AUSA. Inventory that was acquired from ISI has been stated at fair value at July 31, 2007; all subsequent purchases are recorded based on cost. The \$1.0 million of inventory that was acquired from the Fire Quest, Com-Tec, and PDI acquisitions have been stated at fair value at the date of acquisition (see Note 3). At March 31, 2008 and December 31, 2007, the Company's inventory balance was \$1.1 million and \$138,000, respectively, which is included in other current assets on the consolidated balance sheet.

*Property and Equipment*

Property and equipment is stated at cost less accumulated depreciation, except for the plant and equipment acquired in the ISI acquisition which has been recorded at fair value at July 31, 2007; all subsequent purchases are recorded based on cost. The \$1.2 million of property and equipment from the Fire Quest, Com-Tec, and PDI acquisitions have been stated at fair value at the date of acquisition (see Note 3). Depreciation is calculated on the straight-line method.

The Company reviews the carrying value of property and equipment for impairment whenever events and circumstances indicate the carrying value of the asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets. The factors considered by management in performing this assessment include current operating results, trends, and prospects, and the effects of obsolescence, demand, competition, and other economic factors.

*Assets Held Under Capital Leases*

Assets held under capital leases are recorded at the lower of the net present value of the minimum lease payments or the fair value of the asset at the inception of the lease. Amortization expense is computed using the straight-line method over the shorter of the estimated useful life of the asset or the lease term. Assets held under capital leases that were acquired from ISI have been stated at fair value as of July 31, 2007.

## ARGYLE SECURITY, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2008

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)***Goodwill and Other Intangible Assets*

Goodwill represents the excess of consideration paid over the fair value of net assets acquired in the business combination in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Goodwill and other indefinite-lived intangibles (trade name) are not amortized but are tested at least annually for impairment. The Company must recognize an impairment loss if, and to the extent that, goodwill exceeds fair value. The Company has determined that no impairment existed at March 31, 2008.

The Company has two primary reporting units (Corrections and Commercial) that provide different services and products. Accordingly, goodwill was allocated to each. Management believes that the relationship between allocation of identified tangible and intangible assets to be in similar proportion to how goodwill is to be allocated among its reporting units. Accordingly, each reporting division was allocated its share of goodwill based upon its percentage of purchase price allocation related to identified tangible and intangible assets.

Intangible assets that have finite useful lives are amortized over their useful lives which range from 96 to 120 months for customer relationships, 12 to 16 months for backlog and 24 to 36 months for non-competes.

A summary of the activity in goodwill by segment is as follows (in thousands):

	Corrections	Commercial	Total
Balance December 31, 2007	\$ 13,275	\$ 6,662	\$ 19,937
ISI Adjustments	101	(34)	67
Com-Tec Acquisition	2,380		2,380
PDI Acquisition	1,223		1,223
Fire Quest Acquisition		729	729
Balance March 31, 2008	\$ 16,979	\$ 7,357	\$ 24,336

During the first quarter of 2008, the Company increased goodwill from the ISI acquisition by \$67,000 as a result of \$26,000 of additional transaction costs (\$22,000 registration fees and \$4,000 in legal fees), a \$12,000 write-down of stale checks outstanding (decrease in cash), and a \$29,000 reduction in refundable taxes (current tax asset).

*Software Costs*

Software costs represent internally-developed software that is proprietary to the Company and assists in its operations. According to Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the costs of computer software developed or obtained for internal use are to be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use. Management does not believe there is another more rational basis and therefore the assets are amortized on the straight-line basis over a 36-month period.



**ARGYLE SECURITY, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

*Self Insurance*

AUSA and Com-Tec are self-insured to certain limits under its group health and dental plans. On an annual basis, the Company estimates its health insurance cost, for its self insured employee base at AUSA, based upon expected health insurance claims for the current year. The insurance company which provides both the stop loss and total aggregate insurance coverages also provides the average or expected and maximum claims for each class. The average and maximum claims are based on the Company's demographics and prior claim history. The Company uses the average claims history for the trailing twelve months as its basis for accruing health care cost.

*Warranty Reserve*

One of the Company's subsidiaries warrants its products against defects in design, materials and workmanship generally for periods ranging from one to two years. A provision for estimated future costs relating to warranty expense is recorded when products are sold. Management estimates the provision based primarily on historical warranty claim experience. As of March 31, 2008, the warranty reserve was \$118,000 and included in accounts payable and accrued expenses on the unaudited consolidated balance sheet.

*Fair Value of Financial Instruments*

The recorded values of financial instruments, including contracts receivable, other assets, and accounts payable, approximate fair value due to their short maturity. The carrying value of the revolving line of credit approximates fair value due to its variable interest rate. The recorded value of the long-term debt approximates fair value based on borrowing rates currently available to the Company for financing arrangements with similar terms and average maturities.

*Income Taxes*

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded pursuant to FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an

interpretation of FASB No. 109 (FIN 48) and are based on enacted statutory rates to reflect the tax consequences in future years of the differences between the tax bases of assets and liabilities and their financial reporting amounts. Deferred tax assets which will generate future tax benefits are recognized to the extent that realization of such benefits through future taxable earnings or alternative tax strategies in the foreseeable short-term future is more likely than not. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

***Reclassifications***

Prior year balances have been reclassified to conform to current year presentation.

***Recently Issued Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements but does not change existing guidance as to whether or not an instrument is carried at fair value. In February 2008, the FASB released a FASB Staff Position, which delayed the effective date of SFAS No. 157 for all nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the condensed consolidated financial statements on a recurring basis. SFAS No. 157 was first effective for the Company on January 1, 2008. The impact of the adoption of SFAS No. 157 on our financial assets and liabilities, which are principally comprised of cash equivalents, did not have a significant impact on their fair value measurements or require expanded disclosures.

ARGYLE SECURITY, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2008

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities*. SFAS No. 159 permits all entities to choose to elect to measure eligible financial instruments at fair value. SFAS No. 159 applies to fiscal years beginning after November 15, 2007, with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157. The Company elected not to adopt the fair value option for valuation of those assets and liabilities which are eligible, therefore, there is no impact on our financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations a replacement of FASB Statement No. 141*, which significantly changes the principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement is effective prospectively, except for certain retrospective adjustments to deferred tax balances, for fiscal years beginning after December 15, 2008. We are currently evaluating the impact that SFAS No. 141(R) will have on our accounting for acquisitions prior to the effective date of the first fiscal year beginning after December 31, 2008.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. SFAS 160 requires non-controlling interests held by parties other than the parent in subsidiaries be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the impact SFAS No. 160 will have on our financial position and results of operations.

*Use of Estimates*

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

*Contingencies*

Certain conditions may exist as of the date of the consolidated balance sheet, which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company's management and its legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are

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pending against the Company or its subsidiaries or unasserted claims that may result in such proceedings, the Company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims, as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in the Company's consolidated financial statements. If the assessment indicates that a potentially material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed in the notes to the consolidated financial statements.

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed. As of March 31, 2008, the Company did not have any loss contingencies.

## ARGYLE SECURITY, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2008

**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)***Concentrations of Credit Risk*

Financial instruments that potentially expose the Company to concentrations of credit risk, as defined by SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, consist primarily of contract receivables. During the three months ended March 31, 2008, revenue from our top three customers (all from the Corrections segment), represented 42% of total Company revenues. During the three months ended March 31, 2008, the Company had revenues from our top two customers (all from the Corrections segment), which represented 20% and 12% of total Company revenues. See Related-Party Transactions footnote (see Note 19) for discussion of transactions with ISI\*MCS, Ltd.

*Net Income (Loss) Per Share*

Net income (loss) per share (basic) is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Net income (loss) per share (diluted) is calculated by adjusting the number of shares of common stock outstanding using the treasury stock method. Under the treasury stock method, an increase in the fair market value of the Company's common stock results in a greater dilutive effect from outstanding warrants, options, restricted stock awards and convertible securities (common stock equivalents).

The following table reconciles the components of the basic and diluted net income (loss) per share:

	<b>Three Months Ended</b>	
	<b>March 31, 2008</b>	<b>March 31, 2007</b>
Weighted average common shares outstanding - basic	5,749,342	4,781,307
Effect of convertible securities		
Weighted average common shares outstanding - diluted	5,749,342	4,781,307

Stock options to acquire 225,000 shares and promissory notes convertible into 192,500 shares of common stock were excluded from the computation of diluted net income (loss) per share for three months ended March 31, 2008 as the effect of including them would have been anti-dilutive.

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In April 2008, as noted in the Note 22 Subsequent Events, the Company issued 18,750 shares of \$0.001 par value Series A Convertible Preferred Stock pursuant to a \$15.0 million private placement.

### Note 3 Acquisitions

#### *Fire Quest*

On January 1, 2008, MCFSA, all of the partnership interests of which are directly or indirectly wholly owned by AUSA, acquired substantially all of the business assets and liabilities of Fire Quest for a total purchase price of \$1.1 million as follows (in thousands):

Cash	\$	764
Promissory note		250
Transaction costs		116
Net purchase price	\$	1,130

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 3 Acquisitions (continued)*****PDI***

On January 4, 2008, AUSA acquired substantially all of the business assets and liabilities of Peterson Detention, Inc. (PDI) for a total purchase price of \$4.8 million as follows (in thousands):

Cash	\$	1,500
Promissory note		3,000
Transaction costs		251
Net purchase price	\$	4,751

***Com-Tec***

On January 31, 2008, ISI Controls, Ltd. (ISI-Controls), a wholly owned subsidiary of AUSA, which in turn is a wholly owned subsidiary of the Company, closed a transaction, pursuant to which ISI-Controls acquired 100% of the outstanding units of Com-Tec Security, LLC (Com-Tec), resulting in Com-Tec becoming a wholly owned subsidiary of ISI-Controls. The total purchase price for the Com-Tec acquisition was \$6.7 million as follows (in thousands):

Cash	\$	3,000
Promissory note		3,515
Transaction costs		186
Net purchase price	\$	6,701

The Fire Quest, PDI and Com-Tec acquisitions were accounted for as business combinations in accordance with SFAS No. 141. Under the purchase method of accounting, the assets and liabilities acquired were recorded as of the acquisition date at their respective fair values. We have obtained preliminary third party valuations, and the values of certain assets and liabilities are based on these preliminary valuations and are subject to adjustment as additional information is obtained. Such additional information includes, but is not limited to accounts receivable, inventory, and leases. The following table summarizes the estimated fair value of assets acquired and liabilities assumed and related deferred income taxes at the date of the acquisition.

	Fire Quest		PDI		Com-Tec		Total
Current assets	\$	126	\$	2,210	\$	4,638	\$ 6,974
Property and equipment		37		1,126		72	1,235
Goodwill		729		1,223		2,380	4,332

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Customer relationships	90	500	760	1,350
Customer backlog	84	1,270	590	1,944
Trade name			1,300	1,300
Software			250	250
Non-compete agreements	70	250	190	510
Total assets acquired	1,136	6,579	10,180	17,895
Current liabilities	(6)	(738)	(2,619)	(3,363)
Debt		(1,090)	(860)	(1,950)
Total liabilities assumed	(6)	(1,828)	(3,479)	(5,313)
Net purchase price	\$ 1,130	\$ 4,751	\$ 6,701	\$ 12,582



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 3 Acquisitions (continued)**

We have not identified any material unrecorded pre-acquisition contingencies where the related asset, liability, or impairment is probable and the amount can be reasonably estimated. Prior to the end of the one-year purchase price allocation period, if information becomes available that would indicate it is probable that such events had occurred and the amounts can be reasonably estimated, such items will be included in the final purchase price allocation and may adjust goodwill.

**Note 4 Contract Receivables**

Contract receivables consist of the following (in thousands):

	March 31, 2008	December 31, 2007
Completed contracts and contracts in progress	\$ 29,058	\$ 12,126
Retainage	5,785	2,333
Completed contracts and contracts in progress - related parties	8,330	8,468
Retainage - related parties	1,874	2,419
Contract receivables	\$ 45,047	\$ 25,346

**Note 5 Costs and Estimated Earnings on Incomplete Contracts and Backlog Information**

Costs and estimated earnings on incomplete contracts and backlog information are as follows (in thousands):

	Total March 31, 2008	Corrections March 31, 2008	Commercial March 31, 2008
Amended contract amount*	\$ 231,191	\$ 178,504	\$ 52,687
Revenue recognized to date	153,707	112,049	41,658
Unearned contract amount - backlog*	\$ 77,484	\$ 66,455	\$ 11,029
Costs incurred to date	\$ 127,062	\$ 93,770	\$ 33,292
Estimated costs to complete	61,376	52,969	8,407
Estimated total cost	\$ 188,438	\$ 146,739	\$ 41,699
Billings to date	\$ 159,562	\$ 116,869	\$ 42,693
Costs and estimated earnings in excess of billings on incomplete contracts	\$ 5,739	\$ 4,077	\$ 1,662
Billing in excess of costs and estimated earnings on incomplete contracts	\$ 10,105	\$ 7,801	\$ 2,304

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	<b>Total December 31, 2007</b>	<b>Corrections December 31, 2007</b>	<b>Commercial December 31, 2007</b>
Amended contract amount	\$ 196,030	\$ 147,996	\$ 48,034
Revenue recognized to date	109,179	72,978	36,201
Unearned contract amount - backlog	\$ 86,851	\$ 75,018	\$ 11,833
Costs incurred to date	\$ 89,863	\$ 60,583	\$ 29,280
Estimated costs to complete	70,496	61,364	9,132
Estimated total cost	\$ 160,359	\$ 121,947	\$ 38,412
Billings to date	\$ 109,658	\$ 72,372	\$ 37,286
Costs and estimated earnings in excess of billings on incomplete contracts	\$ 7,665	\$ 5,751	\$ 1,914
Billing in excess of costs and estimated earnings on incomplete contracts	\$ 5,733	\$ 3,217	\$ 2,517

\* Backlog associated with PDI is not included in the table above for Total Company and Corrections Segment as the associated revenues are not accounted for under percentage of completion method as defined in SOP 81-1.

The various subsidiary companies often function as subcontractors to other subsidiary companies. The above schedule was computed on a consolidated basis in 2007. The company reorganized in January 2008 to report the business in two segments - Corrections and Commercial (see note 1 and note 20). Since then the Company has determined that the most valid indicator of the next year's performance will be more closely tied to the Corrections backlog versus the Commercial backlog which is more volatile given the shorter nature of completion for the contracts.

Intercompany contract amounts and billings have been eliminated, and costs and estimated earnings in excess of billings and billings in excess of costs and estimated earnings have been recomputed based on actual combined costs of the companies.

Backlog is the aggregate contract amount less revenue recognized using percentage-of-completion accounting as described in Note 2 of these consolidated financial statements. The Company recognizes as backlog only those contracts on which it has received signed contracts or executed letters of intent to award a contract from its customers. The Company also verifies funding is in place on the contracts prior to inclusion in backlog.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 6 Property and Equipment**

Property and equipment consists of the following (in thousands):

	Estimated Useful Lives In Years	March 31, 2008	December 31, 2007
Buildings	10 - 40	1,888	1,888
Leasehold improvements	12	975	593
Furniture, fixtures and equipment	3 - 10	2,591	1,254
Vehicles	3 - 7	2,443	2,189
Website costs	3	39	39
		7,936	5,963
Less - accumulated depreciation		1,219	736
Property and equipment, net		\$ 6,717	\$ 5,227

Depreciation expense relating to property and equipment was \$488,000 and \$1,000 for three months ended March 31, 2008 and 2007, respectively. Depreciation and amortization expense was \$241,000 for the Predecessor period January 1, 2007 through March 31, 2007.

**Note 7 Intangible Assets and Other Assets**

At March 31, 2008, intangible assets consisted of the following (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Amortization Period
<b><u>Amortizable Intangible Assets:</u></b>				
Customer relationships	\$ 12,975	\$ 853	\$ 12,122	113 months
Customer backlog	6,303	2,653	3,650	15 months
Software	550	80	470	36 months
Non-compete	510	42	468	30 months
	\$ 20,338	\$ 3,628	\$ 16,710	
<b><u>Unamortizable Intangible Assets:</u></b>				
Trade name	\$ 5,076	\$	\$ 5,076	

Amortization expense was \$1.7 million for the three months ended March 31, 2008. As of March 31, 2008 and December 31, 2007, intangible assets not subject to amortization included trade names of \$5.1 million and \$3.8 million, respectively. Estimated amortization expense for the next five years and thereafter is as follows (in thousands):

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**Years ending December 31:**

2008 (remaining nine months)	\$	4,791
2009		1,952
2010		1,638
2011		1,389
2012		1,382
Thereafter		5,558
	\$	16,710

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 8 Long-Term Debt**

Notes payable and long-term debt consists of the following (in thousands):

<b>Collateral</b>	<b>March 31, 2008</b>	<b>December 31, 2007</b>
Notes payable:		
Vehicles and equipment	\$ 214	\$ 190
Unsecured debt - related party	11,057	5,952
Unsecured convertible debt - stockholders	1,925	1,925
Seller notes	6,765	
Line of credit and acquisition line	12,970	7,979
	\$ 32,931	\$ 16,046
Less - current maturities	413	81
Long term debt	\$ 32,518	\$ 15,965

***Vehicles and Equipment***

Amounts include notes related to Company vehicles and various equipment lines. Vehicle and equipment notes are staggered in regards to their maturity, each amortizing over 36 - 48 month periods. Interest rates on the individual notes range from fixed rate of 7% up to Prime plus 1.0%. Included with the equipment is a note related to the phone system with a fixed rate of interest at 9.0% which matures in April 2008. The weighted average interest rate for these borrowings was 8.0% and 8.2% at March 31, 2008 and December 31, 2007.

***Unsecured Debt - Related Party***

On January 2, 2008 an additional \$5.0 million in unsecured debt was funded by the same related party for which \$6.0 million was outstanding. All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreements contain prepayment options with prepayment penalties. Interest accrues at 11.58% per annum and is payable quarterly in arrears, deferred interest at the rate of 8.42% per annum, and default interest at 2% per annum. The total debt of \$11.0 million is due and payable in one single payment on January 31, 2010. There are both financial and restrictive covenants associated with the note agreements. As of March 31, 2008, the Company was in compliance with all covenants except two technical, non financial, covenants. The Company obtained a waiver from the lender to remedy these defaults.

***Unsecured Convertible Debt - Stockholders***

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As part of the ISI merger consideration, the Company issued unsecured convertible debt to the stockholders in the amount of \$1.9 million which bears interest at 5% per annum, paid semiannually. The notes mature five years from the date of issuance on July 31, 2012. The notes may be converted in whole or in part into shares of the Company's common stock at the election of the note holder at a share price of \$10.00 any time after January 1, 2008. The debt may be redeemed by the Company at \$10.00 per share any time after January 1, 2009.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 8 Long-Term Debt (continued)**

*Seller Notes*

In connection with the Fire Quest acquisition, the Company issued a promissory note in the aggregate principal amount of \$250,000 (Fire Quest Promissory Note). The Fire Quest Promissory Notes bear interest at the rate of 7.25% per year and will become due and payable on January 1, 2009.

In connection with the PDI acquisition, the Company issued convertible promissory notes (the PDI Promissory Notes) in the aggregate principal amount of \$3.0 million. The aggregate principal amount of the PDI Promissory Notes may be reduced depending on the occurrence of certain events described in the Asset Purchase Agreement. The payment of the PDI Promissory Notes are guaranteed by and secured by the assets of AUSA and Argyle and bear interest at 6% paid quarterly through December 2009. After December 2009, principal and interest payments of \$133,000 are due monthly with final payment occurring on December 31, 2012. On June 1, 2009 through November 15, 2009, the Company has the option to (i) convert \$500,000 of the outstanding principal into common stock of the Company based on 95% of the closing price of the Company's common stock for a 20 day trading period preceding notice of the Company's intent to convert; or (ii) extend the \$500,000 principal due in 2010 to January 3, 2011 for an additional payment of \$15,000 plus accrued interest. The aforementioned options to convert or extend the PDI Promissory Notes have resulted in the creation of compound embedded derivatives for which the Company has performed valuations as of March 31, 2008. The Company will mark to market the derivatives, for which any changes in fair value will be recognized in the statement of operations, in all the subsequent quarters until they are exercised or have expired. The valuations of these derivatives held a nominal value as of March 31, 2008.

In connection with the Com-Tec acquisition, the Company issued a secured subordinated promissory note in the aggregate principal amount of \$3.5 million (the Com-Tec Promissory Note). The Com-Tec Promissory Note is guaranteed by and secured by the assets of AUSA and Argyle, bears interest at 7% per year and will become due and payable on April 1, 2011.

*Line of Credit Facility*

At March 31, 2008, the Company had a line of credit facility totaling \$12.0 million and an acquisition loan facility in the amount of \$4.3 million. The line of credit is secured by all tangible and intangible assets of AUSA excluding vehicles. The line calls for all accounts receivable collections to be deposited directly to a lockbox. The outstanding balance on the credit facility and the acquisition loan facility at March 31, 2008 was \$8.7 million, due January 23, 2010, and \$4.3 million, due June 30, 2011, respectively. Interest is payable quarterly at prime plus 0.75% for the credit facility and at prime plus 1.25% for the acquisition loan through December 31, 2008. After December 31, 2008, the interest rate is based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization ranging from prime to prime plus 0.75% for the credit facility and ranging from prime plus 0.5% to prime plus 1.25% for the acquisition note. The agreement contains both financial and restrictive covenants, including a restriction on the payment of dividends. At March 31, 2008, the Company was in compliance with all covenants except four technical, non financial, covenants. The Company obtained a 90 day extension to remedy two defaults which it believes is probable to cure during the grace period. The Company obtained a waiver from the lender to remedy the remaining two defaults.

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The Company has agreed to pay an annual commitment fee of 0.5% per year on the unused borrowing capacity, which was \$3.3 million and \$1.0 million at March 31, 2008 and December 31, 2007, respectively.

Aggregate maturities required on all debt at March 31, 2008 are as follows (in thousand):

<b>Year Ending December 31:</b>	
2008 (remaining nine months)	\$ 163
2009	292
2010	21,735
2011	7,741
2012	3,000
Thereafter	\$ 32,931



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 9 Capital Leases**

ISI sold its owner-occupied real estate to a partnership owned by ISI's stockholders during 2004 and entered into a leaseback of the properties with the partnership. ISI entered into a second lease on another property owned by the same partnership in 2006. Both leases were triple net leases. A triple net lease is a lease agreement on a property where the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance (the three Nets) on the property in addition to any normal fees that are expected under the agreement (rent, etc.). In such a lease, the tenant or lessee is responsible for all costs associated with repairs or replacement of the structural building elements of the property.

The terms of the aforementioned leases were modified on July 31, 2007 to extend the expiration date from 2018 to 2019. The modification did not materially affect the carrying value of the assets or related liabilities recorded in the accompanying consolidated balance sheet.

The following is a summary of leased property, included in property and equipment, in the accompanying consolidated financial statements:

<b>Collateral</b>	<b>March 31, 2008</b>	<b>December 31, 2007</b>
Buildings	\$ 1,888	\$ 1,888
Less - accumulated amortization	112	69
Net	\$ 1,776	\$ 1,819

The Company reassessed these leases for proper classification under SFAS No. 13, *Accounting for Leases*, and determined they remain properly classified as capital leases. The following is a schedule by years of future minimum lease payments under capital leases together with the present value of net minimum lease payments at March 31, 2008:

<b>Year Ending December 31:</b>	
2008 (remaining nine months)	\$ 216
2009	288
2010	288
2011	288
2012	288
Thereafter	1,917
Future minimum lease payments	\$ 3,285
Less - amount of minimum lease payments attributable to interest	1,307
Present value of net minimum lease payments	\$ 1,978
Current portion of capitalized lease obligations	\$ 107
Long-term portion of capitalized lease obligations	1,871
	\$ 1,978



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 10 Commitments**

AUSA leases office space and equipment under operating leases expiring through 2012. The corporate office lease space of Argyle expired as of July 31, 2007 and Argyle operated under a month-to-month lease arrangement until it was renewed in January 2008. The new lease expands the space from approximately 2,500 square feet to 6,500 square feet for a total expense in 2008 of \$121,000.

As part of the PDI acquisition that occurred at January 4, 2008 the Company assumed the existing leases. The PDI lease is a 4 year lease, for the 42,000 square foot facilities, with monthly payments at \$16,000. As part of the Com-Tec acquisition that occurred at January 31, 2008 the Company signed new leases for the existing facility. The Com-Tec lease is a 5 year lease, for the 33,000 square foot facility, with monthly payments at \$14,000 beginning in year 3 with the total rent expense being recognized on a straight line basis over the life of the lease.

Rental expense was \$196,000 and \$17,000 for the three months ended March 31, 2008 and 2007, respectively, and \$71,000 for the three months ended March 31, 2007 (Predecessor).

Minimum rental commitments at March 31, 2008 are as follows (in thousands):

<b>Year Ending December 31:</b>		
2008 (remaining nine months)	\$	394
2009		421
2010		522
2011		422
2012		312
Thereafter		187
Total commitment outstanding	\$	2,258

In August 2007 the Company entered into a letter of credit facility with a financial institution. The letter of credit may not exceed \$500,000. The facility requires a 1% annual commitment fee on the unused portion of the letter of credit facility and is paid quarterly

**Note 11 Self Insurance**

AUSA and Com-Tec are self-insured to certain limits under its group health and dental plans. Stop-loss coverage is provided for claims above \$75,000 per employee up to a maximum \$0.9 million for AUSA and above \$30,000 per employee up to a maximum of \$2.0 million for Com-Tec. Operations are charged with the cost of claims reported and an estimate of claims incurred but not reported based on prior experience. The determination of such claims and expenses and the appropriateness of the related liability are continually reviewed and updated. Total

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claims payable and claims incurred but not reported were \$0.5 million at March 31, 2008 and \$0.3 million at December 31, 2007. AUSA and Com-Tec have not yet met its stop-loss limit for 2008.

### **Note 12 Offerings**

#### *Public Offering*

In January 2006, Argyle sold 3,700,046 units (which included 75,046 units sold by the underwriters pursuant to a partial exercise of their over-allotment option) to the public at a price of \$8.00 per unit. Each unit consists of one share of the Company's common stock, \$0.0001 par value, and one redeemable common stock purchase warrant (warrant). Each warrant entitles the holder to purchase from the Company one share of common stock at an exercise price of \$5.50 and expiring January 24, 2011. The warrants are redeemable by the Company at a price of \$.01 per warrant upon 30 days' notice, only in the event that the last sale price of the common stock is at least \$11.50 per share for any 20 trading days within a 30-trading-day period ending three business days before a notice of redemption is delivered.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

***Private Placement***

In January 2006, Argyle sold to its officers an aggregate of 125,000 units identical to the units sold in the Public Offering at a price of \$8.00 per unit.

**Note 13 Common Stock Reserved for Issuance**

As of March 31, 2008, 4,087,546 shares of common stock were reserved for issuance upon exercise of redeemable warrants and options and 375,000 shares of common stock were reserved for issuance pursuant to the underwriters' unit purchase option described in Note 17. This includes the warrants that were issued in connection with the April 2007 notes to stockholders entitling the holder to exercise the warrants for a total of 37,500 shares of stock. In 2007, the Company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holder to exercise options for a total of 125,000 shares of stock and 130,000 shares of restricted stock (see Note 17). Additionally, in 2008 the Company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holder to exercise options for a total of 100,000 shares of stock and 85,000 shares of restricted stock (see Note 17).

**Note 14 Redemptive Status of Common Stock**

The registration statement for Argyle's initial public offering indicated that, after signing a definitive agreement for the acquisition of a target business, Argyle would submit such transaction for stockholder approval. Based on the votes submitted, 211,965 shares voted against the proposed ISI business combination and sought to be redeemed for cash. As a result, \$1.7 million of net proceeds from the initial public offering which included interest was redeemed to stockholders in August 2007. The 211,965 shares of common stock were cancelled as of August 2007.

**Note 15 Preferred Stock**

The Company is authorized to issue 1,000,000 shares of preferred stock with such designations, voting, and other rights and preferences, as may be determined from time to time by the Board of Directors. No shares of preferred stock are currently issued or outstanding.

In connection with the merger, and immediately prior to the merger, one of ISI's unsecured debt holders converted \$10.0 million of long-term debt with ISI into shares of ISI preferred stock. Upon closing of the purchase of ISI, the same debt holder received \$10.0 million for the preferred stock of ISI.

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In April 2008, as noted in the Note 22 Subsequent Events, the Company issued 18,750 shares of \$0.001 par value Series A Convertible Preferred Stock pursuant to a \$15.0 million private placement.

### **Note 16 Agreement with Underwriters**

In March 2007, the underwriters from Argyle's Public Offering agreed to forfeit any and all rights or claims to a pro-rata portion of the deferred underwriting costs and associated accrued interest with respect to any shares of common stock that are redeemed in connection with the proposed acquisition. This fee was charged against additional paid-in capital and was payable upon a successful business combination. Based on the redemption of 211,965 shares, \$80,000 related to these waived underwriter fees were paid to redemptive stockholders. Upon closing of the purchase of ISI, Argyle paid approximately \$1.4 million for services performed related to Argyle's Public Offering.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 17 Stockholders' Equity and Stock-Based Compensation**

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share Based Payment*. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Following is a description of the various grants made and the impact to the financial statements.

**2005 2006 Options**

In July 2005, Argyle granted to its officers, directors, and their respective affiliates certain options, which were exercisable only in the event the underwriters exercised the over-allotment option, to purchase that number of shares enabling them to maintain their 20% ownership interest in the Company (without taking into account the units they purchased in the private placement). The measurement date was deemed to be January 30, 2006, the date the over-allotment was exercised because the number of options to be issued was not known until that date.

In January 2006, the underwriters exercised a portion of the over-allotment option in the amount of 75,046 units. In February 2006, the officers and directors exercised their options and purchased 18,761 units for an aggregate cost of \$507 (or \$0.027 per share). The compensation cost, recorded in operating expenses, resulting from these share-based payments was \$130,632 at January 30, 2006, using the Black-Scholes pricing model. This model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The fair value of the options was estimated at the measurement date using the assumptions of weighted-average volatility factor of 0.10; no expected dividend payments; weighted-average risk-free interest rate of 5%; and a weighted-average expected life of 0.13 years.

The fair value of each option was \$6.99 per share. All options vested immediately at the measurement date and no further options may be exercised. Compensation expense was recognized immediately and recorded as an operating expense for the year ended December 31, 2006.

**Underwriter Options**

Argyle sold to its underwriters options to purchase up to an aggregate of 187,500 units for \$100. The units issuable upon exercise of these options are identical to those sold in the Public Offering. These options are exercisable at \$8.80 per unit and expiring January 24, 2011. The options to purchase the 187,500 units and the Securities underlying such units were deemed compensation by the National Association of Securities Dealers (NASD) and were therefore subject to a 180-day lock-up pursuant to Rule 2710(g) (1) of the NASD Conduct Rules.

Argyle accounted for these purchase options as a cost of raising capital and included the instrument as equity in its consolidated balance sheet. Accordingly, there is no net impact on Argyle's financial position or results of operations, except for the recording of the \$100 proceeds from the sale. Argyle has estimated, based upon a Black-Scholes model, that the fair value of the purchase options on the date of sale was approximately

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\$3.40 per unit, (a total value of approximately \$0.6 million) using an expected life of five years, volatility of 44%, and a risk-free rate of 5%. However, because Argyle's units did not have a trading history, the volatility assumption was based on information currently available to management. The volatility estimate was derived using historical data of public companies in the proposed industry. Argyle believes the volatility estimate calculated from these companies was a reasonable benchmark to use in estimating the expected volatility of our units; however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 17 Stockholders' Equity and Stock-Based Compensation (continued)**

***2007 Incentive Plan***

The 2007 Omnibus Securities and Incentive Plan provides for the grant of distribution equivalent rights, incentive stock options, nonqualified stock options, performance share awards, performance unit awards, restricted stock awards, stock appreciation rights, tandem stock appreciation rights, and unrestricted stock awards for an aggregate of not more than 1,000,000 shares of Argyle's common stock, to directors, officers, employees, and consultants of Argyle or its affiliates. If any award expires, is cancelled, or terminates unexercised or is forfeited, the number of shares subject thereto, if any, is again available for grant under the 2007 Incentive Plan. The number of shares of common stock, with respect to which stock options or stock appreciation rights may be granted to a participant under the 2007 Incentive Plan in any calendar year, cannot exceed 150,000.

Except as provided in the 2007 Incentive Plan, awards granted under the 2007 Incentive Plan are not transferable and may be exercised only by the participant or by the participant's guardian or legal representative. Each award agreement will specify, among other things, the effect on an award of the disability, death, retirement, authorized leave of absence or other termination of employment of the participant. Argyle may require a participant to pay Argyle the amount of any required withholding in connection with the grant, vesting, exercise, or disposition of an award. A participant is not considered a stockholder with respect to the shares underlying an award until the shares are issued to the participant.

**Restricted Stock**

On January 25, 2008, the Company granted an aggregate of 85,000 shares of the Company's restricted common stock to certain of its executive officers and directors. Shares granted to the directors vested immediately and shares granted to the executive officers vest one-third on December 31 of each of 2008, 2009 and 2010.

The following table summarizes the restricted stock activity under the 2007 Incentive Plan:

<b>Restricted Stock</b>	<b>Number of Shares</b>	<b>Weighted Average Fair Value Per Share</b>	<b>Average Remaining Vesting Term (Years)</b>
Nonvested at December 31, 2007	110,000	\$ 7.39	
Granted	85,000	7.55	
Vested	30,000	7.55	
Forfeited			

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Nonvested at March 31, 2008	165,000	\$	7.44	2.75
Expected to vest at March 31, 2008	165,000	\$	7.44	2.75
Vested at March 31, 2008		\$		

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 17 Stockholders Equity and Stock-Based Compensation (continued)**

During the three months ended March 31, 2008, the Company recognized \$505,000 in compensation expense, net of tax benefit of \$183,000, related to the Company's issuance of restricted stock. As of March 31, 2008, there was \$910,000 of unrecognized compensation costs, net of estimated forfeitures, related to the Company's non-vested restricted stock, which is expected to be recognized over a weighted average period of 2.75 years.

**Performance Share Awards**

On January 25, 2008, the Company granted an aggregate of 55,000 performance units to certain of its officers, subject to terms and conditions to be set forth in a performance unit agreement and in accordance with the Company's 2007 Incentive Plan. These awards vest on December 31, 2010 if certain performance goals to be determined by the Board of Directors are achieved. The Company recognizes compensation expense on the performance share awards based on the fair value of the underlying common stock at the end of each quarter over the remaining vesting period. The final plan metrics for determination of the award was not approved by the Board of Directors until March 25, 2008. As a result, during the three months ended March 31, 2008, the Company recognized no compensation expense related to the performance share awards. Additionally, no compensation expense was recognized during the year ended December 31, 2007.

The following table summarizes the performance unit activity under the 2007 Incentive Plan:

Performance Units	Number of Units	Weighted Average Fair Value Per Unit	Average Remaining Vesting Term (Years)
Nonvested at December 31, 2007	115,000	\$	
Granted	55,000		
Vested			
Forfeited			
Nonvested at March 31, 2008	170,000	\$	2.75
Expected to vest at March 31, 2008	170,000	\$	2.75
Vested at March 31, 2008		\$	

**Incentive and Nonqualified Stock Options**

On January 25, 2008, the Company granted stock options to purchase an aggregate of 100,000 shares of the Company's common stock to various employees, of which all were ISO. The options have a strike price of \$7.55 and vest December 31 in three equal tranches on each of 2008, 2009 and 2010.



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2008**

**Note 17 Stockholders Equity and Stock-Based Compensation (continued)**

The following table summarizes the stock option activity under the 2007 Incentive Plan:

Stock Options	Number of Shares	Weighted Average Exercise Price Per Share	Average Remaining Vesting Term (Years)	Average Intrinsic Value
Outstanding at December 31, 2007	125,000	\$ 7.89		
Granted	100,000	7.55		
Exercised				
Forfeited				
Outstanding at March 31, 2008	225,000	\$ 7.74	2.75	\$
Vested and expected to vest at March 31, 2008	225,000	\$ 7.74	2.75	\$
Exercisable at March 31, 2008		\$		\$

The Company has estimated, based upon a Black-Scholes model, that the fair value of the stock options granted on January 25, 2008 was approximately \$1.78 per unit, (a total value of approximately \$178,000), using an expected life of three years, volatility of 40%, and a risk-free rate of 2.5%. However, because the shares did not have a trading history, the volatility assumption was based on information currently available to management. The volatility estimate was derived using historical data of public companies in the related industry. The Company believes the volatility estimate calculated from these companies was a reasonable benchmark to use in estimating the expected volatility of our units; however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.

During the three months ended March 31, 2008, the Company recognized \$53,000 in compensation expense, net of tax benefit of \$19,000, related to the Company's stock options. As of March 31, 2008, there was \$341,000 of unrecognized compensation costs, net of estimated forfeitures, related to the Company's non-vested stock options, which is expected to be recognized over a weighted average period of 2.75 years.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 18 Income Taxes**

The provision for income taxes decreased \$444,000 in the first quarter of 2008 compared to the same period in 2007. The decrease in income taxes was primarily due to the decrease in income before income taxes of \$1,230,000. Our effective tax rate was 36.2% in the first quarter of 2008 and 34.2% for the same period in 2007. The increase in our effective tax rate was due to the recognition of additional state income taxes associated with AUSA in 2008.

**Note 19 Related-Party Transactions**

During the quarter ended March 31, 2008 the Company entered into a Board approved agreement with Sec-Tec Global to share certain expenses related to common office space in New York City, New York and administrative type expenses. These expenses are being borne by the Company to reflect realistic expenses associated with the Company's presence to conduct its business. The Company has agreed to share expenses totaling \$175,000 on an annual basis that are to be paid in quarterly payments of \$43,750. Sec Tec Global is a wholly-owned subsidiary of Electronics Line 3000 to which the Company's co-CEOs are stock holders and board members.

At March 31, 2008 and December 31, 2007, other receivables include \$47,000 and \$42,000, respectively, of receivables from related parties, all of which is attributable to AUSA. Amounts represent monies or other assets advanced to employees. Amounts have been paid on these receivables and management believes they are fully collectible.

The Company leases various properties from Green Wing Management, Ltd., an entity owned and controlled by the Chief Executive Officer and President of AUSA under capital leases. The leases on these properties were amended as part of the acquisition of ISI to reflect a term of 12 years ending in 2019 and to require that an appraisal be completed by a qualified appraiser to determine the market rate of the leases. The rental rate to be paid on these properties, after the acquisition of ISI, is limited to no more than 90% of the market rate determined by the third-party appraiser. Additional appraisals by a third-party appraiser are to be conducted every three years during the 12 year terms and the annual lease rate in the leases can increase at the time of these appraisals, but only to a level that does not exceed 90% of the market rate determined by the third-party appraiser. Argyle has the right to purchase these three properties at any time, at the then current market value; however, the purchase price cannot be less than the value determined in the last appraisal preceding the effective date of the acquisition of ISI. During the three months ended March 31, 2008, the Company made lease payments of \$72,000 under these leases. See Note 9 for the remaining payments due under these leases.

In conjunction with the major refinancing of ISI in 2004, the majority stockholders formed a new company in 2004 (ISI\*MCS, Ltd.) which was used as the contracting entity on all future bonded contracts. ISI transferred certain existing bonded contracts at their remaining contract values, and no gain or loss was recognized on the transfers to ISI\*MCS, Ltd. at the time of its formation. All contracts of ISI\*MCS, Ltd. were subcontracted to ISI for the full contract amount, less a 2% fee. AUSA recorded contract revenue based on the ISI\*MCS, Ltd.'s contract amount, net of the 2% fee. Contract receivables from ISI\*MCS, Ltd. at March 31, 2008 and December 31, 2007 totaled \$10.2 million and \$10.9 million, respectively, which is disclosed as contract receivables - related party on the face of the consolidated balance sheet since ISI\*MCS, Ltd. is not consolidated in the balance sheet. Contract revenues reported by the Company from ISI\*MCS, Ltd. were \$6.9 million for the three months ended

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March 31, 2008. ISI\*MCS, Ltd. revenues reported by the predecessor (ISI) were \$5.8 million for the three months ended March 31, 2007. Argyle has agreed to indemnify the shareholders of ISI\*MCS, Ltd. from claims brought by the bonding company against their personal guarantees for those contracts that have not been paid in full as of the closing of the merger. The merger agreement provides that these indemnification obligations will survive for a period of four years after the closing date of the merger and the obligations are not subject to cap, or maximum amount.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 19 Related-Party Transactions (continued)**

Subsequent to July 31, 2007, AUSA will receive 100% of the remaining contract amounts and ISI\*MCS, Ltd. will forego its 2% fee. Remaining amounts to be billed on these contracts as of March 31, 2008 totaled \$11.5 million. All future contracts, bonded and un-bonded, will be contracted directly by AUSA without involvement by ISI\*MCS, Ltd.

**Unsecured Debt Related Party**

As part of the ISI merger transaction, debt totaling \$16.0 million was owed to a shareholder of ISI, of which \$10.0 million was paid prior to its original terms. The shareholder became a shareholder of Argyle as part of the merger and holds 486,237 shares of Argyle common stock as of July 31, 2007 and as such, became a related party. At March 31, 2008 and December 31, 2007, the remaining debt to the shareholder (see Note 8) totaled \$11.1 million and \$6.0 million, respectively.

**Note 20 Segment Information**

The Company's segments are strategic business units that offer different products and services and are managed accordingly. Under GAAP segment reporting rules, management analyzes the various operating segments based on segment income before income taxes. During the first quarter of 2008, the Company changed its segment reporting to better align the Company's recently acquired companies with its existing business units and its global and strategic direction. This change resulted in ISI Detention and MSC Detention combining into the Corrections reportable segment and MCS Commercial into the Commercial reporting segment. Segment information for the Predecessor for the three months ended March 31, 2007 has been restated to conform to current year presentation. The customers and long-lived assets of the reportable segments are in the United States.

AUSA is a detention and commercial equipment contractor that specializes in turnkey installations, including design, engineering, supply, and installation of various detention equipment for correctional facilities and institutions. The work is performed under fixed-price contracts. The projects are located in various cities in the United States. The length of the contracts varies but is typically less than two years. AUSA also provides turnkey installations covering the full spectrum of electronic security and low voltage systems, including fire alarm, access control, closed circuit television, intercom, sound/paging, and other custom designed systems.

Argyle Corrections consists of all of our businesses in the corrections sector including ISI, Metroplex Control Systems (MCS) as well as Com-Tec Security LLC (Com-Tec) and Peterson Detention, Inc. (PDI). Com-Tec and PDI were acquired in January 2008. This segment includes:



- ISI (also referred to historically as ISI-Detention) designs, engineers, supplies, installs, and maintains a full array of detention systems and equipment, targeting correctional facilities throughout the United States;
- Metroplex Control Systems (also referred to historically as MCS-Detention) designs, engineers, supplies, installs and maintains complex, customized security, access control, video and electronic security control system solutions at correctional and government facilities;
- PDI is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories; and
- Com-Tec is an industry leader in the custom design and manufacture of electronic security and communications systems.

**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 20 Segment Information (continued)**

Argyle Corrections offers a complete array of electronic security system solutions revolving around electronic locking systems and hardware, security doors and frames, jail furniture, security glazing, and other security-based systems and specializes in turnkey installations for public- and privately-owned/operated detention facilities in designs, assembles, supplies, installs, and maintains access control, video, and integrated electronic control systems for correctional and government facilities throughout the United States. It also provides the above goods and services to detention market integrators, electrical contractors, and competitors of AUSA that lack their own in-house electronic solutions. Whether acting as prime contractor or as a subcontractor for projects spanning all levels of security, Corrections' product offerings include security locking systems, security hollow metal doors and wall panels, security windows, security glass and glazing, security furnishings and accessories, design support, and full installation capabilities.

Argyle Commercial Security has built a parallel business to Corrections targeting commercial and industrial facilities. Argyle Commercial Security group focuses on the commercial security sector and provides turnkey, electronic security systems to the commercial market. Currently, MCS Commercial Fire & Security is the only member of this segment and is referred to historically as MCS-Commercial. Commercial currently operates out of its own San Antonio headquarters and five regional offices. The offices in Austin, Houston, and Denver resulted from acquisitions made by ISI.

<b>Industry Segment (in thousands)</b>	<b>Three Months Ended</b>		<b>Predecessor (ISI)</b>	
	<b>March 31,</b>		<b>Three Months Ended</b>	
	<b>2008</b>		<b>March 31,</b>	
			<b>2007</b>	
<b>Revenues:</b>				
Corrections	\$	30,038	\$	9,970
Commercial		7,559		8,882
Corporate				
Eliminations				
<b>Total</b>	<b>\$</b>	<b>37,597</b>	<b>\$</b>	<b>18,852</b>
<b>Operating income (loss):</b>				
Corrections	\$	1,610	\$	798
Commercial		(136)		402
Corporate		(1,852)		
Eliminations				
<b>Total</b>	<b>\$</b>	<b>(378)</b>	<b>\$</b>	<b>1,200</b>
<b>Total assets:</b>				
Corrections	\$	99,920	\$	27,250
Commercial		5,752		4,818
Corporate		37,353		
Eliminations		(34,158)		
<b>Total</b>	<b>\$</b>	<b>108,867</b>	<b>\$</b>	<b>32,068</b>
<b>Capital expenditures:</b>				
Corrections	\$	650	\$	414
Commercial		121		120
Corporate		10		
<b>Total</b>	<b>\$</b>	<b>781</b>	<b>\$</b>	<b>534</b>



**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2008**

**Note 21 Supplemental Disclosures of Cash Flow Information**

	Three Months Ended		Predecessor (ISI)
	March 31, 2008	March 31, 2007	Three Months Ended March 31, 2007
Cash paid for interest	\$ 489	\$	\$
Cash paid for income taxes	300		
<b>Supplemental schedule of non-cash investing activities:</b>			
Accrual for deferred transaction costs	\$ 405	\$ 174	\$
<b>Supplemental schedule of non-cash financing activities:</b>			
Notes issued for acquisitions	\$ 6,765	\$	\$
Accrual of offering costs	302		

**Note 22 Subsequent Events**

In April 2008, the Company issued 18,750 shares of \$0.0001 par value Series A Convertible Preferred Stock for aggregate proceeds of \$15.0 million. The preferred stock accrue dividends at a rate of 3% per annum and are convertible into 100 shares of the Company's common stock at any time at the option of the holder at a conversion price of \$8.00 per share. Upon liquidation (voluntary or otherwise), dissolution, winding up or a change of control of the Company, holders of the Series A Preferred Stock will be entitled to receive, from the assets of the Company available for distribution, the greater of the original issue price plus accrued but unpaid dividends or the amount the holder would receive if all the Series A Preferred Stock were converted into shares of Common Stock. Series A Convertible Preferred Stock holders have no voting rights. The Series A Preferred Stock will be classified in Stockholders' Equity on the Company's Consolidated Balance Sheet.

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

### Forward Looking Statements

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, should, could, would, expect, plan, anticipate, believe, estimate, the negative of such terms or other similar expressions. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those described in our other Securities and Exchange Commission filings. The following discussion should be read in conjunction with our unaudited Financial Statements and related Notes thereto included elsewhere in this report.

### Overview

Argyle Security, Inc. is a Delaware corporation incorporated on June 22, 2005 in order to serve as a vehicle for the acquisition of an operating business through a merger, capital stock exchange, asset acquisition or other similar business combination. Argyle completed its initial public offering in January 2006. As provided in its certificate of incorporation, Argyle was required, by July 30, 2007, to consummate a business combination or enter a letter of intent, agreement in principle or definitive agreement relating to a business combination, in which case Argyle would be allowed an additional six months to complete the transactions contemplated by such agreement.

On July 31, 2007, pursuant to the terms of a merger agreement, dated December 8, 2006, as amended on June 29, 2007 and July 11, 2007 (the Merger Agreement), Argyle acquired all of the assets and liabilities of ISI-Detention Contracting Group, Inc. (ISI), currently referred to as Argyle Security USA (AUSA). As a result of the merger, ISI now referred to as AUSA became a wholly owned subsidiary of Argyle. AUSA is a provider of physical security solutions to commercial, governmental and correctional customers.

In February 2008, we reorganized our business under the name of Argyle Security USA, or AUSA, through which we provide physical security solutions to commercial, governmental, and correctional customers. Argyle Security USA has two reporting segments, Argyle Corrections and Argyle Commercial Security.

Argyle Corrections consists of all of our businesses in the corrections sector including ISI, Metroplex Control Systems (MCS) as well as Com-Tec Security LLC (Com-Tec) and Peterson Detention, Inc. (PDI). Com-Tec and PDI were acquired in January 2008. This segment includes:

- ISI (also referred to historically as ISI-Detention) designs, engineers, supplies, installs, and maintains a full array of detention systems and equipment, targeting correctional facilities throughout the United States;

- Metroplex Control Systems (also referred to historically as MCS-Detention) designs, engineers, supplies, installs and maintains complex, customized security, access control, video and electronic security control system solutions at correctional and government facilities;
- PDI is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories; and
- Com-Tec is an industry leader in the custom design and manufacture of electronic security and communications systems.

Argyle Commercial Security focuses on the commercial security sector and provides turnkey, electronic security systems to the commercial market. Currently, MCS Commercial Fire & Security is the only member of this group and is referred to historically as MCS-Commercial.

On January 1, 2008, MCFSA, Ltd. (MCFSA), all of the partnership interests of which are directly or indirectly wholly owned by AUSA, acquired substantially all of the business assets and liabilities of Fire Quest Inc. (Fire Quest). Fire Quest is engaged in the business of alarm system sales and service.

On January 4, 2008, AUSA acquired substantially all of the business assets and liabilities of PDI. PDI is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories.

On January 31, 2008, ISI Controls, Ltd. (ISI-Controls), a wholly owned subsidiary of AUSA, which in turn is a wholly owned subsidiary of the Company, closed a transaction, pursuant to which ISI-Controls acquired 100% of the outstanding units of Com-Tec Security, LLC (Com-Tec), resulting in Com-Tec becoming a wholly owned subsidiary of ISI-Controls. Com-Tec is engaged in the business of custom design, manufacture and installation of electronic security and communication systems.

### **Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations is based on the accompanying consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. As such, we are required 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. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. Our management reviews its estimates on an on-going basis, including those related to revenue recognition based on the percentage-of-completion methodology, sales allowances, recognition of service sales revenues, the allowance for doubtful accounts, inventories and related reserves, long-lived assets, investments and income taxes. We base our estimates and assumptions on historical experience, knowledge of current conditions and our understanding of what we believe to be reasonable that might occur in the future considering available information. Actual results may differ from these estimates, and material effects on our operating results and financial position may result.

*Percentage-of-Completion Estimates* - AUSA uses percentage-of-completion accounting to determine revenue and gross margin earned on projects. Estimating the percentage completion on a project is a major critical estimate that AUSA depends on. This estimate is determined as follows:

#### Construction Contracts:

- The contract amount and all contract estimates are input into a job cost accounting system with detail of all significant estimates of purchases by vendor type, subcontractor, and labor.
- As the project is performed and purchases and costs are incurred, these are recorded in the same detail as the original estimate.
- The contract amount and estimated contract costs are updated monthly to record the effect of any contract change order received.
- On a monthly basis, management, along with project managers who are overseeing the contracts, review these estimated costs to complete the project and compare them to the original estimate and the estimate that was used in the prior month to

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determine the percentage-of-completion. If the cost to complete, determined by management and the project managers for the current month, confirms that the estimate used in the prior month is correct, then no action is taken to change the estimate and/or the percentage complete in that current month. However, if the current cost to complete estimate calculated by the management and the project managers differs, then adjustments are made. If the costs are in excess of the estimate used in the prior month, then a decrease in the percentage complete on the project through the current month in the accounting period is made. If the costs are less than the estimate used in the prior accounting period, then the new estimate increases the percentage complete on the project.

- Revenues from construction contracts are recognized on the percentage-of-completion method in accordance with SOP 81-1. AUSA recognizes revenues on signed contracts and change orders. AUSA generally recognizes revenues on unsigned change orders where it has written notices to proceed from the customer and where collection is deemed probable. Percentage-of-completion for construction contracts is measured principally by the percentage of costs incurred and accrued to date for each contract to the estimated total costs for each contract at completion. AUSA generally considers contracts to be substantially complete upon departure from the work site and acceptance by the customer. If any jobs are identified during the review process which are estimated to be a loss job (where estimated costs exceed contract price), the entire estimated loss is recorded in full, without regard to the computed percentage of completion.



These estimates of percentage completion of a project determine the amounts of revenues and gross margin that are earned to date on a project. For example, if a contract is \$100,000 with a 20% gross margin of \$20,000, then a project that is estimated to be 50% complete accrues \$50,000 in revenues and \$10,000 in gross margin. If the percentage completed is adjusted to 25%, then the revenues on the contract would be \$25,000, and the earned gross margin would be \$5,000. These estimates would be changed in the current month, and the actual accrual of the revenue and gross margin earned on this project would be reduced in the current month.

Another effect of the change in the estimated costs and percentage complete is that it changes the percentage of gross margin earned. For example, in the project mentioned above, if the estimated costs changed to 90% from 80% because of projected cost overruns, this would then reduce the gross margin percentage to 10% from 20%. Management attempts to recognize losses (overruns of cost estimates) as soon as they can be quantified. Management attempts to recognize gains (under-runs of cost estimates) when they can be quantified and are certain.

Costs incurred prior to award of contracts are expensed as incurred. The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the customer. Based on the Company's experience with similar contracts in recent years, the retention balance at each balance sheet date will be collected within the subsequent fiscal year.

The current asset *Costs and estimated earnings in excess of billings on incomplete contracts* represents revenues recognized in excess of amounts billed which management believes will be billed and collected within the subsequent year. The current liability *Billings in excess of costs and estimated earnings on incomplete contracts* represents billings in excess of revenues recognized.

*Service Sales* - Service revenues are recognized when the services have been delivered to and accepted by the customer. These are generally short-term projects which are evidenced by signed service agreements or customer work orders or purchase orders. These sales agreements/customer orders generally provide for billing to customers based on time at quoted hourly or project rates, plus costs of materials and supplies furnished by the Company.

*IBNR Estimates for Health Insurance* - On an annual basis, Argyle estimates its health insurance cost, for its self-insured employee base at the acquired companies AUSA and Com-Tec, based upon expected health insurance claims for the current year. The insurance company which provides both the stop loss and total aggregate insurance coverages also provides the average or expected and maximum claims for each class. The average and maximum claims are based on our demographics and prior claim history. Argyle uses the average claims history for the trailing the twelve months as its basis for accruing health care cost. This accrual is automated and is part of the payroll function for each pay period.

*Deferred income taxes* - Deferred income taxes are provided for temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts for tax purposes. Valuation allowances are provided against the deferred tax asset amounts when the realization is uncertain.

*Allowance for Doubtful Accounts* - Argyle provides an allowance for bad debt through an analysis in which the bad debts that had been written off over a previous period are compared on a percentage basis to the aggregate sales for the

same period. The resulting percentage is applied to the sales for year to date and a monthly reserve is accrued accordingly. Additionally, management analyzes specific customer accounts receivable for any potentially uncollectible accounts and will add such accounts to the reserve or write them off if warranted, after considering lien and bond rights, and then considers the adequacy of the remaining unallocated reserve compared to the remaining accounts receivable balance (net of specific doubtful accounts).

*Non Cash Compensation Expense* - On January 1, 2006, Argyle adopted SFAS No. 123 (revised 2004), *Share Based Payment*. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values.

Purchase options (ISO / non-qualified) grants:

On a quarterly basis, Argyle computes the value of newly issued purchase options (ISO and non-qualified) by utilizing the Black-Scholes valuation model based upon their expected life vesting period, industry comparables for volatility and the risk-free rate on US Government securities with matching maturities. The value of the purchase options are then straight-line expensed over the life of the purchase options.

Restricted and performance stock grants:

On a quarterly basis, Argyle computes the value of newly issued stock grants based on the share price as of the award date. The values of the common shares are then straight-line expensed over the life of the corresponding vesting period.

The Company recognizes compensation expense on the performance share awards based on the fair value of the underlying common stock at the end of each quarter over the remaining vesting period.

#### **Pro Forma and Adjusted Pro Forma Financial Information**

Since we acquired ISI in July 2007 and Fire Quest, PDI and Com-Tec in January 2008, we do not believe a comparison of the results of operations and cash flows for the three months ended March 31, 2008 versus March 31, 2007 is beneficial to our stockholders. In order to assist investors in better understanding the changes in our business between the three months ended March 31, 2007 and March 31, 2008, we are presenting in management's discussion and analysis section below in the pro forma and adjusted pro forma results of operations for the Company and the acquisitions for the three months ended March 31, 2008 and March 31, 2007 as if the acquisitions occurred on January 1, 2008 and January 1, 2007, respectively. We derived the pro forma results and adjusted pro forma results of operations from (i) the unaudited consolidated financial statements of ISI from January 1, 2007 to March 31, 2007, (ii) the unaudited consolidated financial statements of Com-Tec for the one month ended January 31, 2008 and the three months ended March 31, 2007, (iii) the unaudited financial statements of PDI for the three months ended March 31, 2007, (iv) the unaudited financial statements of Fire Quest for the three months ended March 31, 2007 and (v) the unaudited consolidated financial statements of the Company for the three months ended March 31, 2008 and 2007. We are presenting the pro forma and the adjusted pro forma information in order to provide a more meaningful comparison of our operating results with prior periods. The

Adjusted pro forma net income is an alternative view of performance used by management and we believe that investors' understanding of our performance is enhanced by disclosing this performance measure. We report adjusted pro forma net income in order to present the results of our major operations - the construction, installation, marketing, and sale of various electronic security systems for commercial accounts and detention hardware (including security doors and frames, jail furniture, security glazing, and other security-based systems) and electronic control systems for correctional facilities - prior to considering certain income statement elements, principally amortization of intangible assets. **We have defined adjusted pro forma net income as net income before the impact of purchase accounting for acquisitions, acquisition-related**

**costs, discontinued operations and certain significant items including one time expenses associated with stock appreciation rights. The adjusted pro forma net income measure is not, and should not be viewed as, a substitute for U.S. GAAP net income.**

The adjusted pro forma net income measure is an important internal measurement for us. We measure the performance of the overall Company on this basis. The following are examples of how the adjusted pro forma net income measure is being utilized:

- Senior management receives a monthly analysis of our operating results that is prepared on an adjusted pro forma net income basis;
- Our annual budgets are prepared on an adjusted pro forma net income basis; and
- Annual and long-term compensation, including annual cash bonuses, merit-based salary adjustment, and share-based payments for various levels of management will consider financial measures that include adjusted pro forma net income and the associated earnings per share. The adjusted pro forma net income measure will represent a significant portion of target objectives that are utilized to determine the annual compensation for various levels of management, although the actual weighting of the objective may vary by level of management and job responsibility and may be considered in the determination of certain long-term compensation plans.

Despite the importance of this measure to management in goal setting and performance measurement, we stress that adjusted pro forma net income is a non-GAAP financial measure that has no standardized meaning under US-GAAP and therefore, has limits in its usefulness to investors. Because of its non-standardized definition, adjusted pro forma net income (unlike U.S. GAAP net income) may not be comparable with the calculation of similar measures for other companies. Adjusted pro forma net income is presented solely to permit investors to more fully understand how management assesses our performance.

**We also recognize that, as an internal measure of performance, the adjusted pro forma net income and the associated earnings per share measure has limitations and we do not restrict our performance-management process solely to this metric. A limitation of the adjusted pro forma net income measure is that it provides a view of our operations without including all events during a period such as the effects of an acquisition or amortization of purchased intangibles and does not provide a comparable view of our performance to other companies in the security detention and construction industry.**

**In addition, annual and long-term compensation, including annual cash bonuses, merit-based salary adjustments and share-based payments for various levels of management that will be made in future years will likely include a non-discretionary formula that measures our performance using revenue growth and relative total shareholder return.**

EBITDA is used by management as a performance measure for benchmarking against the Company's peers and competitors. The Company believes EBITDA is useful to investors because it is frequently used by securities analysts, investors and other interested parties to evaluate companies in the security industry. Additionally, we use EBITDA for internal performance measurements. EBITDA is not a recognized term under GAAP. Argyle and AUSA compute EBITDA using the same consistent method from quarter to quarter. EBITDA includes net income, interest, taxes, depreciation, and amortization. The presentation of EBITDA is not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with GAAP.

The adjusted pro forma results of operations are not necessarily indicative of the results of operations that may have actually occurred had the merger taken place on the dates noted, or the future financial position or operating results of us or AUSA. The pro forma adjustments are based upon available information and assumptions that we believe are reasonable. The presentation of EBITDA (earnings before interest, taxes, depreciation and amortization) and adjusted pro forms results is not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with GAAP.

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Below is a table showing Argyle's Adjusted Pro Forma Consolidated Statements of Operations. The Pro Forma Consolidated Statements of Operations are included in the notes to the financial statements included elsewhere in this report.

**Argyle Security, Inc**

**Adjusted Pro Forma Consolidated Statements of Operations**

**(unaudited)**

(in thousands except share data)

	<b>Three Months Ended</b>	
	<b>March 31, 2008</b>	<b>March 31, 2007</b>
<b>Revenues:</b>		
Contract revenues	\$ 26,906	\$ 11,806
Contract revenues - related party	6,943	5,801
Service and other revenues	5,466	5,566
<b>Total revenues</b>	<b>39,315</b>	<b>23,173</b>
<b>Cost of revenues:</b>		
Contract costs	27,040	13,813
Service and other costs, excluding amortization of intangibles	4,270	4,332
<b>Total cost of revenues</b>	<b>31,310</b>	<b>18,145</b>
Gross profit	8,005	5,028
<b>Operating expenses:</b>		
Salaries and related expense, including \$558 stock-based compensation in 2008	3,577	2,489
Consulting fees and outside services	948	295
Depreciation	462	302
Other general and administrative expenses	1,668	1,165
Amortization of intangible assets		
<b>Total operating expenses</b>	<b>6,655</b>	<b>4,251</b>
Operating income	1,350	777
<b>Other income (expense):</b>		
Interest income	26	59
Interest expense	(844)	(754)
<b>Total other income (expense)</b>	<b>(818)</b>	<b>(695)</b>
Income before provision for income taxes	532	82
Provision (benefit) for income taxes	207	(33)
<b>Net income (loss)</b>	<b>\$ 325</b>	<b>\$ 115</b>
<b>EBITDA Calculation:</b>		
Interest, net	\$ 818	\$ 695
Depreciation	462	352
Taxes, net	207	(33)
<b>EBITDA</b>	<b>\$ 1,812</b>	<b>\$ 1,129</b>
<b>Weighted-average number of shares outstanding:</b>		
Basic	5,749,342	5,749,342
Diluted	6,707,072	6,751,123
<b>Net income per share:</b>		
Basic	\$ 0.06	\$ 0.02

Diluted

\$

0.05

\$

0.02

Below is a reconciliation of GAAP net income (loss) to: pro forma net income (loss); adjusted pro forma net income (loss); and to pro forma EBITDA. **The presentation of EBITDA is not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with GAAP.**

### Reconciliation of GAAP Net Income to Pro Forma Net Income

#### Adjusted Pro Forma Net Income and Pro Forma EBITDA

(unaudited)

(in thousands)

	Three Months Ended	
	March 31, 2008	March 31, 2007
<b>GAAP net income (loss)</b>	<b>\$ (734)</b>	<b>\$ 52</b>
Pro forma adjustments - addbacks (reductions)		
Argyle salary expense (increase) for management team in 2007		(222)
Non-cash compensation expense (increase) for 2007		(142)
Depreciation expense (increase) on revalued assets in 2007		(78)
Amortization of intangible expense (increase) in cost of goods sold for 2008 and 2007	(37)	(1,289)
Amortization of intangible expense (increase) in operating expenses for 2008 and 2007	(21)	(354)
Reduction in rent expense for 2008 and 2007	5	17
Interest income increase / (reduction) for 2008 and 2007		(324)
Interest expense (increase) / reduction for 2008 and 2007	(39)	247
Income / (loss) from predecessor - Argyle Security USA for Q1 2007		123
Income / (loss) from predecessor - Firequest for Q1 2007		80
Income / (loss) from predecessor - PDI for Q1 2007		156
Income / (loss) from predecessor - Com-Tec for January 2008 and Q1 2007	44	(38)
Provision (benefit) for income taxes on pro forma adjustments for 2008 and 2007	34	815
<b>Pro forma net income (loss)</b>	<b>\$ (748)</b>	<b>\$ (957)</b>
Amortization of intangible expense in cost of goods sold for 2008 and 2007	1,289	1,289
Amortization of intangible expense in operating expenses for 2008 and 2007	442	442
Provision (benefit) for income taxes on pro forma adjustments for 2008 and 2007	(658)	(659)
<b>Adjusted pro forma net income (loss)</b>	<b>\$ 325</b>	<b>\$ 115</b>
Interest, net	818	695
Depreciation expense	462	352
Taxes, net	207	(33)
<b>Pro forma EBITDA</b>	<b>\$ 1,812</b>	<b>\$ 1,129</b>



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Below is a table of adjusted pro forma revenues, cost of sales, and gross margins for the three months ended March 31, 2008 and 2007.

	Three Months March 31, 2008			Three Months March 31, 2007			Percent Increase (Decrease)			
	Corrections	Commercial	Total	Corrections	Commercial	Total	Corrections	Commercial	Total	
<b>Net revenues</b>										
Contract revenues /										
contract revenues -										
related party	\$ 28,251	\$ 5,598	\$ 33,849	\$ 12,101	\$ 5,506	\$ 17,607	133.5%	1.7%	92.2%	
Service and other										
revenues	3,505	1,961	5,466	1,914	3,652	5,566	83.1%	-46.3%	-1.8%	
Total net revenues	\$ 31,756	\$ 7,559	\$ 39,315	\$ 14,015	\$ 9,158	\$ 23,173	126.6%	-17.5%	69.7%	
<i>% of total</i>										
<b>Cost of revenues</b>										
Contract costs /										
contract costs -										
related party	\$ 22,595	\$ 4,445	\$ 27,040	\$ 9,245	\$ 4,568	\$ 13,813	144.4%	-2.7%	95.8%	
Service and other										
costs	2,620	1,650	4,270	1,320	3,012	4,332	98.5%	-45.2%	-1.4%	
Total cost of										
revenues	\$ 25,215	\$ 6,095	\$ 31,310	\$ 10,565	\$ 7,580	\$ 18,145	138.7%	-19.6%	72.6%	
<b>Gross margin</b>										
Contract margins /										
contract margins -										
related party	\$ 5,656	\$ 1,153	\$ 6,809	\$ 2,856	\$ 938	\$ 3,794	98.0%	22.9%	79.5%	
Service and other										
margins	\$ 885	\$ 311	\$ 1,196	594	640	1,234	-49.0%	-51.4%	-3.1%	
Total gross margin	\$ 6,541	\$ 1,464	\$ 8,005	\$ 3,450	\$ 1,578	\$ 5,028	89.6%	-7.2%	59.2%	
<b>Gross margin percentage</b>										
Contract revenues /										
contract revenues -										
related party	20.0%	20.6%	20.1%	23.6%	17.0%	21.5%	-15.3%	21.2%	-6.5%	
Service and other										
revenues	25.2%	15.9%	21.9%	31.0%	17.5%	22.2%	18.7%	-9.1%	-1.4%	
Total gross margin										
percentage	20.6%	19.4%	20.4%	24.6%	17.2%	21.7%	-16.3%	12.8%	-6.0%	

Corrections segment revenues increased by 126.7% of total Company revenues from the same period in 2007. Commercial segment revenues fell by 17.5%, but when a single \$1.8 million service revenue transaction in 2007 is excluded, the growth for the same period was 2.7%. The total Company margin decrease from 21.7% to 20.4% was directly attributable to the decreased margins in the Corrections segment (decreased 16.3%) while the Commercial segment margins increased by 12.8% over the same period.

## Discussion of Financial Results

### Revenues

More than 90% of AUSA's revenues are generated by fixed-price contracts. The success of a fixed-price contract is based in large part upon the quality of the process utilized when estimating the costs that will be incurred in performing the contract. The larger the project and the longer the term of completion of the contract, the greater the number of variable factors there are to be considered and evaluated in estimating costs. A successful estimating process requires substantial experience and judgment. Management is aware of the significant need for experience and qualified estimating personnel and regularly monitors the estimating process and its results.

The most obvious benchmark that management considers in evaluating the estimating process is whether the amount estimated, and submitted as a bid, was reasonably similar to the amount bid by AUSA's competitors on the same project. Other bidders may bid exceptionally low (even at a loss) in order to secure a contract that the competitor may desperately need in order to maintain at least a modest level of cash flow, or for other reasons. Management must evaluate the bids that were submitted in competition with AUSA's bid, based on their knowledge of each competitor's history and character (for example, some typically bid high, some typically bid low), the condition of the market, the complexity of the project, the type of construction and other factors. This review, conducted regularly, provides management with an ongoing general basis for evaluating the estimating process that result in fixed price contracts. Evaluating the results of bidding competitions allows management to evaluate the Company's estimating capabilities at the beginning or front-end of a new contract or project. Other benchmarks are used to evaluate the estimating process while a project is ongoing.

AUSA also generates service revenues. These are generally short-term projects which are evidenced by signed service agreements, customer work orders or purchase orders. These sales agreements/customer orders generally provide for billing to customers based on time at quoted hourly or project rates, plus costs of materials and supplies furnished by AUSA. Service revenues are recognized when the services have been delivered to and accepted by the customer.

This is our third quarter of reportable revenues. Prior to our acquisition of AUSA, we had no revenues.

*Cost of Revenues*

Cost of revenues consists of the direct costs to complete a material fixed-price contract and includes variable costs related to the project, such as material, direct labor, project management costs, travel related expenses to the projects, hotel costs spent while the project is on-going, truck expenses utilized on those projects and cell phones of the personnel while they are on those projects. We also review our inventories for indications of obsolescence or impairment and provide reserves as deemed necessary.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses consist primarily of salaries and benefits for selling and administrative personnel, including the human resources, executive, finance and legal. These expenses also include fees for professional services and other administrative expenses.

**Results of Operations for the Three Months Ended March 31, 2008**

**Revenues**

This is our third quarter of reportable revenues. Prior to our acquisition of AUSA, we had no revenues.

*Pro Forma Net Revenues*

The following table presents pro forma net revenues for the three months ended March 31, 2008 and 2007 (in thousands):

<b>Pro Forma Revenue</b>		
<b>Three Months Ended March 31, 2008</b>	<b>Three Months Ended March 31, 2007</b>	<b>Year to Year</b>

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	Amount	% of Revenues	Amount	% of Revenues	Increase (Decrease)	
					Amount	%
<b>Contract revenues</b>	\$ 26,906	68.4%	\$ 11,806	51.0%	\$ 15,100	127.9%
<b>Contract revenues - related party</b>	6,943	17.7%	5,801	25.0%	1,142	19.7%
<b>Service and other revenues</b>	5,466	13.9%	5,566	24.0%	(100)	-1.8%
<b>Total revenues</b>	\$ 39,315	100.0%	\$ 23,173	100.0%	\$ 16,142	69.7%

On a pro forma basis, the Company had revenues of \$39.3 million (including related party revenue of \$6.9 million) and \$23.2 million (including related party revenue of \$5.8 million) for the three months ended March 31, 2008 and 2007, respectively, representing an increase of \$16.1 million or 69.7%. The significant increase in contract revenues is primarily due to several major factors including, but not limited to, the addition of new products through the development of internal software applications that has allowed the company to capture a larger part of its market. Year over year service revenues have decreased by (\$0.1) million for the quarter ended March 31, 2008 versus 2007. There is such a significant decrease because we had an unusually large \$1.8 million service revenue contract recognized in the same period 2007. When excluding the \$1.8 million opportunity in the quarter-ended March 31, 2007 service and other sales actually increased by \$1.7 million or 45.1% over the same period. The Company has focused on building its service revenue base by adding salespeople and improving performance to retain more customers and to the increase service revenues.

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As used in this analysis, related party revenue is that revenue that is generated by work sub-contracted from ISI\*MCS (an entity owned by Sam Youngblood, President of AUSA, and by Don Carr, President of AUSA - Corrections). Messrs. Youngblood and Carr created ISI\*MCS in 2004 to provide bonding on contracts that required bonding. The performance of those contracts was subcontracted to ISI as a subcontractor to ISI\*MCS. The sub-contracted work was for third party customers of ISI\*MCS that required bonded contracts. After the acquisition of ISI by Argyle, ISI\*MCS no longer provided bonding and subcontract work to ISI now referred to AUSA in 2008. AUSA is in the process of securing its own bonding capacity and will use that bonding capacity to directly enter into bonded contracts with third party customers. After the merger, the amount of Revenues - related party will continue to decrease as the contracts with ISI\*MCS, outstanding at the time of the merger, are completed.

The pro forma revenue mix was 86.1% contract revenues and 13.9% service revenues for the three months ended March 31, 2008 compared to 76.0% and 24.0%, respectively, for the corresponding period in 2007.

In the last three years the entire corrections and commercial security markets have been growing, which has been a factor in a portion of the Company's success. Should these markets continue to grow, the Company with its strong market position should continue to see increasing revenue opportunities. Since January 2008, the Company has been implementing plans to increase revenues. Some of the expected increases will be derived from the marketing of packaged products from the portfolios of the companies Argyle acquired in January 2008.

### Cost of Revenues

This has been our third quarter of reportable cost of revenues. Prior to our acquisition of AUSA, we had no cost of revenues.

#### *Adjusted Pro Forma Cost of Revenues*

The following table reconciles adjusted pro forma cost of revenues to pro forma cost of revenues for the three months ended March 31, 2008 and 2007 (in thousands):

	Adjusted Pro Forma Cost of Revenue		Adjusted Pro Forma Cost of Revenue		Year to Year	
	Three Months Ended		Three Months Ended		Increase (Decrease)	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Contract costs</b>	\$ 27,040	68.8%	\$ 13,813	59.6%	\$ 13,227	95.8%
<b>Service and other costs, excluding amortization of intangibles</b>	4,270	10.9%	4,332	18.7%	(62)	-1.4%
<b>Adjusted pro forma total cost of revenues</b>	31,310	79.6%	18,145	78.3%	13,165	72.6%
<b>Amortization of intangibles</b>	1,289	3.3%	1,289	5.6%		0.0%
<b>Pro forma cost of revenues, including amortization of intangibles</b>	\$ 32,599	82.9%	\$ 19,434	83.9%	\$ 13,165	67.7%

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On a pro forma basis, cost of revenues increased by \$13.2 million, or 67.9%, to \$32.6 million for the three months ended March 31, 2008, compared to \$19.4 million for the corresponding period in 2007. On an adjusted pro forma basis, cost of revenues increased by \$13.2 million, or 72.6%, to \$31.3 million for the three months ended March 31, 2008, compared to \$18.1 million for the corresponding period in 2007. The increase in cost of sales resulted from AUSA working on a greater number of projects in 2008 than in 2007.

The amortization of acquired backlog has been allocated to cost of revenues. The impact of this amortization (which was excluded from adjusted pro forma cost of revenues) for the three months ended March 31, 2008 was \$1.3 million.

The Company has been implementing its plan to reduce costs and improve efficiencies. Some of these efforts include implementing the best technology in all organizations. For example, we discovered that some of the technology used by the acquired companies was superior to our own, especially with respect to production costs. Additionally, we discovered that some of the technology we developed is faster and more efficient than that of the acquired companies. The current effort to swap technology is proceeding as planned and production cost savings are expected results of these efforts.

## Gross Margin

This has been our third quarter of reportable gross margin. Prior to our acquisition of AUSA, we had no gross margin.

### *Adjusted Pro Forma Gross Margin*

The following table reconciles adjusted pro forma gross margin to pro forma gross margin for the three months ended March 31, 2008 and 2007 (in thousands):

	Adjusted Pro Forma Gross Margin		Three Months Ended		Year to Year	
	Three Months Ended		Three Months Ended		Increase (Decrease)	
	March 31, 2008		March 31, 2007		Amount	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Adjusted pro forma gross margin</b>	\$ 8,005	20.4%	\$ 5,028	21.7%	\$ 2,977	59.2%
<b>Amortization of intangibles</b>	(1,289)	-3.3%	(1,289)	-5.6%		0.0%
<b>Pro forma gross margin</b>	\$ 6,716	17.1%	\$ 3,739	16.1%	\$ 2,977	79.6%

On a pro forma basis for the three months ended March 31, 2008, there was gross margin of \$6.7 million compared to a gross margin of \$3.8 million for the corresponding period in 2007. On an adjusted pro forma basis for the three months ended March 31, 2008, there was gross margin of \$8.0 million compared to a gross margin of \$5.0 million for the corresponding period in 2007. The increase in adjusted gross margin was directly attributable to the Company's stronger pricing position which provides higher margins and development of software to automate production, which allows for efficiencies in production and thus lowers costs, thus increasing gross margins. A major contributor to the increase in gross margin is the increase in service revenues as a percentage of the overall revenues. Service revenues enjoy a higher gross margin than the contract revenues. The company also increased gross margin by controlling costs through the upgrading of project management processes to support installations and services.

The amortization of acquired backlog in the cost of sales section has been allocated to cost of revenues and represents the only difference between pro forma gross margins and adjusted pro forma gross margins for the three months ended March 31, 2008 and 2007.

As previously discussed in revenues and cost of revenues sections Argyle has been implementing its plans to increase revenues, improve efficiencies, and reduce costs, all with the expectation to improve gross margins in coming periods. Argyle has also seen margins improve over the last year due to the following:

- Lower margin work was completed in prior years and quarters;
- Service revenues with higher margins continue to increase, therefore increasing overall margin percentages;  
and
- Production and delivery variable costs have been reduced through software tools development, code compression, and training which has improved margin percentages.



**Operating Expenses**

Operating expenses consist primarily of salaries and benefits for selling and administrative personnel, including human resources, executive, finance, and legal. These expenses also include fees for professional services and other administrative expenses as well as amortization of intangible assets. Operating expenses increased to \$6.8 million for the three months ended March 31, 2008, compared to \$0.3 million for the corresponding period in 2007. Substantially all of the expense increase is attributed to the acquisition of ISI on July 31, 2007 and Com-Tec, PDI , and Fire Quest in the quarter ended March 31, 2008.

*Adjusted Pro Forma Operating Expenses*

The following table reconciles adjusted pro forma operating expenses to pro forma operating expenses for the three months ended March 31, 2008 and 2007 (in thousands):

	Adjusted Pro Forma Operating Expenses		Adjusted Pro Forma Operating Expenses		Year to Year	
	Three Months Ended		Three Months Ended		Increase (Decrease)	
	March 31, 2008		March 31, 2007		Amount	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Adjusted pro forma total operating expenses</b>	\$ 6,655	16.9%	\$ 4,251	18.3%	\$ 2,404	56.6%
<b>Amortization of intangible assets</b>	442	1.1%	442	1.9%		0.0%
<b>Pro forma total operating expenses</b>	\$ 7,097	18.1%	\$ 4,693	20.3%	\$ 2,404	51.2%

On a pro forma basis, operating expenses increased \$2.4 million, or 51.2% to \$7.1 million for the three months ended March 31, 2008 from \$4.7 million for the corresponding period in 2007. On an adjusted pro forma basis, operating expenses increased \$2.4 million, or 56.6% to \$6.7 million for the three months ended March 31, 2008 from \$4.3 million for the corresponding period in 2007. The increase is primarily due to additional expenses needed to support the increased number of projects on which AUSA is working, increased sales and marketing efforts to promote future growth, and corporate services expenses associated with the parent company entity. Growth in operating expenses for 2008 is planned at approximately the same rate as the growth in revenues to build infrastructure to support growth in the coming years

Additionally, \$0.6 million in non-cash compensation expense related to restricted stock grants and employee stock options was included in the operating expenses for the quarter ended March 31, 2008 and \$0.2 million for the same period in 2007. The amortization of customer base and software has been allocated to operating expenses and primarily relates to the acquisition of ISI on July 31, 2007 and Com-Tec, PDI , and Fire Quest in the quarter ended March 31, 2008. The impact of this amortization, which was excluded from pro forma operating expenses, was \$0.4 million.

**Other Income / Expense**

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Prior to July 2007, total other income/expense represented interest earned on the net proceeds of our initial public offering and the private placement held in trust through the date of the acquisition of ISI. Interest expense represents interest on our line of credit, unsecured subordinated debt, and notes issued in January 2008 in connection with the acquisition of Com-Tec, PDI, and Fire Quest. Total other income/expense for the three months ended March 31, 2008 was an expense of \$0.8 million compared to income of \$0.4 million for the corresponding period in 2007.

### *Pro Forma Interest Income and Interest Expense*

The following table presents pro forma interest and other income for the three months ended March 31, 2008 and 2007 (in thousands):

	Pro Forma Other Income (Expense)		Pro Forma Other Income (Expense)		Year to Year	
	Three Months Ended		Three Months Ended		Increase (Decrease)	
	March 31, 2008		March 31, 2007		Amount	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Interest income</b>	\$ 26	0.1%	\$ 59	0.3%	\$ (33)	-55.9%
<b>Interest expense</b>	(844)	-2.1%	(754)	-3.3%	(90)	11.9%
<b>Total other income (expense)</b>	\$ (818)	-2.1%	\$ (695)	-3.0%	\$ (123)	17.7%

Pro forma net interest for the three months ended March 31, 2008 mainly represents interest earned on the net proceeds of our initial public offering and the private placement held in trust through the date of the acquisition of ISI. Interest expense increased to (\$0.8) million for the three months ended March 31, 2008 from (\$0.7) million for the corresponding period in 2007. Interest expense for the three months ended March 31, 2008 and 2007 mainly represents interest on our line of credit, unsecured subordinated debt, and our notes issued in January 2008 for the acquisition of Com-Tec, PDI and Fire Quest.

**Net Income / (Loss)**

For the three months ended March 31, 2008, we had net loss of (\$0.7) million compared to a net income of \$52,000 for the corresponding period in 2007. The results of operations for the three months ended March 31, 2008 include the results of operations for AUSA, Fire Quest and PDI from January 1, 2008 and the results of operations of Com-Tec from February 1, 2008. Our primary source of income prior to the consummation of our initial business combination with ISI was interest earned on the funds held in the trust account.

*Adjusted Pro Forma Net Income (Loss)*

The following table reconciles adjusted pro forma net income (loss) to pro forma income / (loss) for the three months ended March 31, 2008 and 2007 (in thousands):

	Pro Forma Net Income (Loss)		Pro Forma Net Income (Loss)		Year to Year	
	Three Months Ended		Three Months Ended		Increase (Decrease)	
	March 31, 2008		March 31, 2007		Amount	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Adjusted pro forma net income (loss)</b>	\$ 325	0.8%	\$ 115	0.5%	\$ 210	182.6%
<b>Amortization of intangible assets</b>	(1,731)	-4.4%	(1,731)	-7.5%		0.0%
<b>Taxes, net</b>	658	1.7%	659	2.8%	(1)	-0.2%
<b>Total pro forma net income (loss)</b>	\$ (748)	-1.9%	\$ (957)	-4.1%	\$ 209	-21.8%

For the three months ended March 31, 2008, we had a pro forma net loss of (\$0.7) million compared to a pro forma net loss of (\$1.0) million for the corresponding period in 2007. For the three months ended March 31, 2008, we had an adjusted pro forma net income of \$0.3 million compared to an adjusted pro forma net income of \$115,000 for the corresponding period in 2007. The adjusted pro forma results for the three months ended March 31, 2008 include the pro forma results of operations for AUSA, Fire Quest and PDI from January 1, 2008 and the results of operations of Com-Tec from February 1, 2008. Our primary source of income prior to the consummation of our initial business combination with AUSA was interest earned on the funds held in a trust account.

**Earnings before Interest, Taxes, Depreciation and Amortization ( EBITDA )**

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	Pro Forma EBITDA					
	Three Months Ended March 31, 2008			Three Months Ended March 31, 2007		
	Amount	% of Revenues		Amount	% of Revenues	Year to Year Increase (Decrease) Amount %
<b>Pro forma EBITDA</b>	\$ 1,812	4.6%	\$	1,129	4.9%	\$ 683 60.5%

Pro forma EBITDA rose by \$0.7 million to \$1.8 million in the three months ended March 31, 2008, compared to \$1.1 million in the corresponding period in 2007. The EBITDA margin decreased to 4.5 % from 4.9% in the corresponding period in 2007. The March 31, 2008 EBITDA includes \$0.6 million in non-cash compensation expense related to restricted stock grants and employee stock options for that period compared to \$0.2 million for the same period in 2007.

## Liquidity and Capital Resources

As of March 31, 2008, we had \$2.5 million in cash and cash equivalents.

In January 2006, Argyle completed a private placement of 125,000 units to its executive officers and their affiliates and received net proceeds of approximately \$0.9 million. On January 30, 2006, Argyle consummated its initial public offering of 3,700,046 units (which included 75,046 units sold as part of the underwriter's over-allotment option). Each unit in both the private placement and the public offering consisted of one share of common stock and one redeemable common stock purchase warrant. Each warrant entitles the holder to purchase from Argyle one share of Argyle's common stock at an exercise price of \$5.50 per share.

Net proceeds from the sale of Argyle's units, after deducting certain offering expenses of approximately \$2.4 million, including underwriting discounts of approximately \$1.8 million, were approximately \$28.2 million. Approximately \$27.3 million of the proceeds from the Public Offering and the Private Placement were placed in a trust account for Argyle's benefit. Except for \$0.6 million in interest that was earned on the funds contained in the trust account and that was released to Argyle to be used as working capital, and the amounts released to Argyle for the payment of taxes, Argyle was not able to access the amounts held in the trust until it consummated a business combination. The amounts held outside of the trust account were used by Argyle to provide for business, legal, and accounting due diligence on prospective acquisitions and continuing general and administrative expenses. Prior to releasing the funds held in trust, the trust account contained \$1.4 million reserved for the compensation of Argyle's underwriters in its Public Offering which was paid to them upon completion of the business combination. All amounts held in trust were released at July 31, 2007 to fund the ISI acquisition.

In connection with the Public Offering and the Private Placement, Argyle's officers and directors placed all the shares owned by them before the Private Placement and the Public Offering into an escrow account. Except in certain circumstances, the shares held in escrow may not be released prior to January 24, 2009.

On April 16, 2007, Argyle's officers and directors, an affiliate of Bob Marbut, Argyle's Chairman and Co-Chief Executive Officer, and certain of Argyle's consultants, pursuant to a note and warrant acquisition agreement, loaned Argyle an aggregate of \$0.3 million and in exchange received promissory notes in the aggregate principal amount of \$0.3 million and warrants to purchase an aggregate of 37,500 shares of Argyle's common stock. The promissory notes were repaid in full plus accrued interest in August 2007.

On July 31, 2007, Argyle consummated a business combination, acquiring 100% of the outstanding capital stock of ISI Detention Contracting Group, Inc. and its subsidiaries, the value of which the Board of Directors determined was greater than 80% of Argyle's assets at the time of the merger. Prior to the acquisition of ISI, Argyle had no operations and was considered a developmental stage enterprise. ISI is deemed to be a predecessor to the combined company. The accompanying consolidated balance sheet includes the assets and liabilities related to the acquisition of ISI, adjusted to fair value pursuant to Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*.

Argyle used an estimated \$20.5 million (excluding Argyle and AUSA transaction costs) of the net proceeds of the initial public offering to acquire ISI. At the closing of the merger, the following consideration was paid by the Company to the stockholders and debt holders of ISI:

- \$18.6 million in cash;

- 1,180,000 shares of common stock of Argyle (valued at approximately \$9.2 million); and
- \$1.9 million of unsecured promissory notes convertible into shares of common stock of the Company at a conversion price of \$10 per share.

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Additionally, Argyle incurred total transaction costs of approximately \$1.7 million, including legal costs paid to Loeb & Loeb of \$0.5 million, \$0.6 million related to certain Macquarie Securities (USA) Inc.'s (formerly Giuliani Capital Advisors) advisory fees and fairness opinion, \$0.3 million paid in M&A fees to WFG Investments and additional costs of \$0.3 million related to accountants, consultants, printer fees and other miscellaneous expenses. Such costs do not include transaction costs of approximately \$1.0 million incurred by ISI (related primarily to attorney, brokerage and accounting fees).

As part of the ISI merger, public stockholders holding 211,965 of the aggregate number of shares sold in the Public Offering elected to redeem such shares. The per share redemption price was equal to \$7.80 per share including interest earned thereon in the trust account, net of taxes paid and payable, \$0.6 million of interest income which was released from the trust account in September 2006 to fund our working capital, and amounts owed to the underwriter for the Private Placement (approximately \$0.5 million plus interest). Approximately \$1.6 million was paid to redemptive shareholders in August of 2007.

In April 2008, Argyle completed a private placement of 18,750 shares of Series A Convertible Preferred Stock (convertible initially into 1,875,000 shares of common stock) to two accredited investors and received gross proceeds of \$15 million. Rodman & Renshaw, LLC, a wholly owned subsidiary of Rodman & Renshaw Capital Group, Inc., served as the exclusive placement agent for the offering and received \$900,000 and 112,500 warrants to purchase an aggregate of 112,500 shares of Argyle's common stock; exercisable at \$8.00 per share as a placement fee.

### *Working Capital*

Our primary liquidity needs are for financing AUSA's working capital (including premiums and fees incurred in connection with bid and performance bonds) and their purchase of computers and related equipment. The nature of its business and operations as a detention contractor causes cash flow from operations to be highly volatile. Its large construction contracts can produce or consume cash. The production or consumption of cash is dependent on factors inherent to the construction industry, including billing and payment terms of the contracts. AUSA has in place a credit facility to allow it to manage its working capital requirements.

At March 31, 2008, we had current assets of \$59.1 million and current liabilities of \$31.9 million resulting in a working capital surplus of approximately \$27.2 million compared to a surplus of \$20.0 million at December 31, 2007.

### *Long-Term Debt*

Notes payable and long-term debt consists of the following (in thousands):

<b>Collateral</b>	<b>March 31, 2008</b>	<b>December 31, 2007</b>
Notes payable:		
Vehicles and equipment	\$ 214	\$ 190
Unsecured debt - related party	11,057	5,952
Unsecured convertible debt - stockholders	1,925	1,925
Seller notes	6,765	

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Line of credit and acquisition line		12,970		7,979
	\$	32,931	\$	16,046
Less - current maturities		413		81
Long term debt	\$	32,518	\$	15,965

*Vehicles and Equipment*

Amount includes notes related to Company vehicles and various equipment. Vehicle and equipment notes are staggered in regards to their maturity, each amortizing over 36 - 48 month periods. Interest rates on the individual notes range from fixed rate of 7% up to Prime plus 1.0%. Included with the equipment is a note related to the phone system with a fixed rate of interest at 9.0% which matures in April 2008.



***Unsecured Debt Related Party***

These refer to notes payable to a significant stockholder of Argyle. On January 2, 2008 an additional \$5.0 million in unsecured debt was funded by the same related party for which \$6.0 million is due. All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreements contain prepayment options with prepayment penalties. Interest accrues at 11.58% per annum and is payable quarterly in arrears, deferred interest at the rate of 8.42% per annum, and default interest at 2% per annum. The total debt of \$11.0 million is due and payable in one single payment on January 31, 2010. There are both financial and restrictive covenants associated with the note agreements. As of March 31, 2008, the Company was in compliance with all covenants except two technical, non financial, covenants. The Company obtained a waiver from the lender to remedy these defaults.

***Unsecured Convertible Debt Stockholders***

As part of the ISI merger consideration, the Company issued unsecured convertible debt to the stockholders in the amount of \$1.9 million which bears interest at 5% per annum, paid semiannually. The notes mature five years from the date of issuance on July 31, 2012. The notes may be converted in whole or in part into shares of the Company's common stock at the election of the note holder at a share price of \$10.00 any time after January 1, 2008. The debt may be redeemed by the Company at \$10.00 per share any time after January 1, 2009.

***Unsecured Debt Stockholders***

In April 2007, Argyle's officers and directors, an affiliate of Argyle's Chairman and Co-Chief Executive Officer, and certain of Argyle's consultants, pursuant to a note and warrant acquisition agreement, loaned Argyle an aggregate of \$0.3 million and in exchange received promissory notes in the aggregate principal amount of \$0.3 million and warrants to purchase an aggregate of 37,500 shares of Argyle's common stock. The warrants are exercisable at \$5.50 per share of common stock and expire on January 24, 2011.

The warrants also may be exercised on a net-share basis by the holders of the warrants. The Company has estimated, based upon a Black-Scholes model, that the fair value of the warrants on the date of issue was approximately \$2.48 per warrant (a total value of approximately \$93,000 using an expected life of 2 years, volatility of 2.39%, and a risk-free rate of 5%. However, because the Company's warrants have a limited trading history, the volatility assumption was based on information currently available to management. The promissory notes had an interest at a rate of 4% per year and were repayable 30 days after the consummation of a business combination. The notes and the associated accrued interest were paid in full in August 2007.

***Seller Notes***

In connection with the Fire Quest acquisition, the Company issued a promissory note in the aggregate principal amount of \$250,000 (Fire Quest Promissory Note). The Fire Quest Promissory Notes bear interest at the rate of 7.25% per year and will become due and payable on January 1, 2009.

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In connection with the PDI acquisition, the Company issued convertible promissory notes (the PDI Promissory Notes) in the aggregate principal amount of \$3.0 million. The aggregate principal amount of the PDI Promissory Notes may be reduced depending on the occurrence of certain events described in the Asset Purchase Agreement. The payment of the PDI Promissory Notes are guaranteed by and secured by the assets of AUSA and Argyle and bear interest at 6% paid quarterly through December 2009. After December 2009, principal and interest payments of \$133,000 are due monthly with final payment occurring on December 31, 2012. On June 1, 2009 through November 15, 2009, the Company has the option to (i) convert \$500,000 of the outstanding principal into common stock of the Company based on 95% of the closing price of the Company's common stock for a 20 day trading period; or (ii) extend the payment date to January 3, 2011 for an additional payment of \$15,000 plus accrued interest. The aforementioned options to convert or extend the PDI Promissory Notes have resulted in the creation of compound embedded derivatives for which the Company has performed valuations as of March 31, 2008. The Company will mark to market the derivatives, for which any changes in fair value will be recognized in the statement of operations, in all the subsequent quarters until they are exercised or have expired. The valuations of these derivatives held a nominal value as of March 31, 2008.

In connection with the Com-Tec acquisition, the Company issued a secured subordinated promissory note in the aggregate principal amount of \$3.5 million (the Com-Tec Promissory Note). The Com-Tec Promissory Note is guaranteed by and secured by the assets of AUSA and Argyle, bears interest at 7% per year and will become due and payable on April 1, 2011.

***Line of Credit Facility***

At March 31, 2008, the Company had a line of credit facility totaling \$12.0 million and an acquisition loan facility in the amount of \$4.3 million. The line of credit is secured by all tangible and intangible assets of AUSA excluding vehicles. The line calls for all accounts receivable collections to be deposited directly to a lockbox. The outstanding balance on the credit facility and the acquisition loan facility at March 31, 2008 was \$8.7 million, due January 23, 2010, and \$4.3 million, due June 30, 2011, respectively. Interest is payable quarterly at prime plus 0.75% for the credit facility and at prime plus 1.25% for the acquisition loan through December 31, 2008. After December 31, 2008, the interest rate is based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization ranging from prime to prime plus 0.75% for the credit facility and ranging from prime plus 0.5% to prime plus 1.25% for the acquisition note. The agreement contains both financial and restrictive covenants, including a restriction on the payment of dividends. The Company obtained a 90 day extension to remedy two defaults which it believes is probable to cure during the grace period. The Company obtained a waiver from the lender to remedy the remaining two defaults. In the event that the Company does not receive a permanent waiver or cure by other means during the 90 day extension period, Argyle may cure such default by agreeing to guarantee the obligations of AUSA to its senior lender.

The Company has agreed to pay an annual commitment fee of 0.5% per year on the unused borrowing capacity, which was \$3.3 million and \$1.0 million at March 31, 2008 and December 31, 2007, respectively.

***Capital Leases***

ISI sold its owner-occupied real estate to a partnership owned by ISI's stockholders during 2004 and entered into a leaseback of the properties with the partnership. ISI entered into a second lease on another property owned by the same partnership in 2006. Both leases were triple net leases. A triple net lease is a lease agreement on a property where the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance (the three Nets) on the property in addition to any normal fees that are expected under the agreement (rent, etc.). In such a lease, the tenant or lessee is responsible for all costs associated with repairs or replacement of the structural building elements of the property.

The terms of the aforementioned leases were modified on July 31, 2007 to extend the expiration date from 2018 to 2019 and increase the monthly rental from \$23,667 to \$24,000. The modification did not materially affect the carrying value of the assets or related liabilities recorded in the accompanying consolidated balance sheet. The Company reassessed these leases for proper classification under SFAS No. 13, *Accounting for Leases*, and determined they remain properly classified as capital leases.

***Commitments***

AUSA leases office space and equipment under operating leases expiring through 2012. The corporate office lease space of Argyle expired as of July 31, 2007 and Argyle operated under a month-to-month lease arrangement until it was renewed in January 2008. The new lease expands the space from approximately 2,500 square feet to 6,500 square feet for a total expense in 2008 of \$121,000. Rental expense was \$196,000 and \$17,000 for the three months ended March 31, 2008 and 2007, respectively, and \$71,000 for the three months ended March 31, 2007 (Predecessor).

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As part of the PDI acquisition that occurred at January 4, 2008 the Company assumed the existing leases. The PDI lease is a 4 year lease, for the 42,000 square foot facilities, with monthly payments at \$16,000. As part of the Com-Tec acquisition that occurred at January 31, 2008 the Company signed new leases for the existing facility. The Com-Tec lease is a 5 year lease, for the 33,000 square foot facility, with month payments at \$14,000 beginning in year 3 with the total rent expense being straight line amortized over the life of the lease.

In August 2007 we entered into a letter of credit facility with a financial institution. The letter of credit may not exceed \$500,000. The facility requires a 1% annual commitment fee on the unused portion of the letter of credit facility. The commitment fee is to be paid quarterly.

### **Off Balance Sheet Arrangements**

Argyle does not have any off-balance sheet arrangements.

**Contractual Obligations**

**Contractual Obligations as of March 31, 2008  
(Unaudited)**

	<b>Total</b>	<b>&lt; 1 Year</b>	<b>1- 3 Years</b>	<b>3 - 5 Years</b>	<b>&gt; 5 Years</b>
Principal on Long Term Debt Obligations	\$ 32,931	\$ 413	\$ 21,777	\$ 10,741	\$
Capital Lease Obligations	3,285	216	576	576	1,917
Operating Lease Obligations	2,258	394	943	734	187
Interest on Long Term Debt Obligations	9,495	3,380	4,717	1,398	
<b>Total</b>	<b>\$ 47,969</b>	<b>\$ 4,403</b>	<b>\$ 28,013</b>	<b>\$ 13,449</b>	<b>\$ 2,104</b>

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the sensitivity of income to changes in interest rates, foreign exchanges, commodity prices, equity prices, and other market-driven rates or prices.

At March 31, 2008, the Company had a line of credit facility totaling \$12.0 million and an acquisition loan facility in the amount of \$4.3 million. The line of credit is secured by all tangible and intangible assets of AUSA excluding vehicles. The outstanding balance on the credit facility and the acquisition loan facility at March 31, 2008 was \$8.7 million, due January 23, 2010, and \$4.3 million, due June 30, 2011, respectively. Interest is payable quarterly at prime plus 0.75% for the credit facility and at prime plus 1.25% for the acquisition loan through December 31, 2008. After December 31, 2008, the interest rate is based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization ranging from prime to prime plus 0.75% for the credit facility and ranging from prime plus 0.5% to prime plus 1.25% for the acquisition note.

Changes in market rates may impact the bank's LIBOR rate or prime rate. For instance, if either the LIBOR or prime rate were to increase or decrease by one percentage point (1.0%), our annual interest expense would change by approximately \$163,000 based on the total credit available to Argyle.

### ITEM 4. CONTROLS AND PROCEDURES

An evaluation of the effectiveness of our disclosure controls and procedures as of March 31, 2008 was made under the supervision and with the participation of our management. Based on that evaluation, our management concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Management has excluded ISI, PDI, Com-Tec, and Fire Quest which was integrated into the Commercial segment from its evaluation of internal control over financial reporting as of March 31, 2008. ISI was acquired on July 31, 2007, Fire Quest was acquired on January 1, 2008, PDI was acquired on January 4, 2008, and Com-Tec was acquired on January 31, 2008. Argyle was a shell company when it acquired ISI and each of PDI, Fire Quest and Com-Tec would be considered significant subsidiaries of Argyle.

During the most recently completed fiscal quarter, there has been no significant change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

From time to time, the Company has various lawsuits, claims, and contingent liabilities arising from the conduct of its business; however, in the opinion of management, they are not expected to have a material adverse effect on the combined results of operations, cash flows, or financial position of the Company.

### ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. In addition to the risk factors contained in our Annual Report on form 10-K, you should also consider the following:

*We derive a significant portion of our revenues from a small number of customers and the loss of a significant customer could significantly reduce our revenues.*

Our customer base and revenues are concentrated among a limited number of customers and the loss of any one of these customers could significantly reduce our revenues. During the three months ended March 31, 2008, revenue from our top three customers, which were all from the Corrections segment, represented 42% of total Company revenues. During the three months ended March 31, 2008, the Company had revenues from our top two customers, which were all from the Corrections segment, which represented 20% and 12% of total Company revenues.

*If outstanding public warrants are exercised, the underlying common shares will be eligible for future resale in the public market. Market overhang from the warrants results in dilution and could keep the market price of our stock lower than it would otherwise be.*

Outstanding public warrants and unit purchase options to purchase an aggregate of 4,075,046 shares of common stock issued in connection with Argyle's initial public offering and those for services rendered in connection with a financing transaction are currently exercisable. If they are exercised, a substantial number of additional shares of our common stock will be eligible for resale in the public market, which could keep the market price of our stock lower than it would otherwise be.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In April 2008, Argyle completed a private placement of 18,750 shares of Series A Convertible Preferred Stock (convertible initially into 1,875,000 shares of common stock) to two accredited investors and received gross proceeds of \$15 million. Argyle issued warrants to purchase 112,500 shares of its common stock, exercisable at \$8.00 per share, to Rodman & Renshaw, LLC, which served as the exclusive placement agent for the offering, as a portion of its placement fee. Argyle did not pay any fees in connection with the issuance of the warrants. The securities were issued in reliance on the exemption from registration contained in Section 4(2) of the Securities Act since Rodman is an accredited investor.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

**ITEM 5. OTHER INFORMATION**

None.



**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of the Co-Chief Executive Officer (Principal Executive Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
31.2	Certification of the Co-Chief Executive Officer (Principal Executive Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
31.3	Certification of the Chief Financial Officer (Principal Accounting Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended
32.1	Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARGYLE SECURITY, INC

May 20, 2008                      By:                      /s/ Bob Marbut  
Bob Marbut  
Co-Chief Executive Officer  
(Principal Executive Officer)

May 20, 2008                      By:                      /s/ Ron Chaimovski  
Ron Chaimovski  
Co-Chief Executive Officer  
(Principal Executive Officer)

May 20, 2008                      By:                      /s/ Donald F. Neville  
Donald F. Neville  
Chief Financial Officer  
(Principal Accounting and  
Financial Officer)