

TRI-S SECURITY CORP
Form 10-K
April 14, 2009
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2008

.. **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 0-51148

Tri-S Security Corporation

(Exact name of registrant as specified in its charter)

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Georgia
(State or other jurisdiction of
incorporation or organization)

30-0016962
(I.R.S. Employer
Identification No.)

Royal Centre One
11675 Great Oaks Way
Suite 120
Alpharetta, GA 30022

(Address of principal executive offices)

(678) 808-1540

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: common stock, par value \$0.001 per share; and warrants to purchase common stock, par value \$0.001 per share

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

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

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

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

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>

(Do not check if a smaller reporting company)

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

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

The aggregate market value of the voting and non-voting common equity held by non-affiliates completed by reference to the price at which the common equity was last sold as of the last business day of the registrant's most recently completed second fiscal quarter is \$7,450,660.

As of April 13, 2009, 4,203,280 shares of common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE: The information required by Part III of this Annual Report is incorporated by reference to the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Annual Report.

Table of Contents

Annual Report

on

Form 10-K

For the Year Ended December 31, 2008

Table of Contents

	Page
<u>PART I</u>	
Item 1. <u>Business</u>	1
Item 1A. <u>Risk Factors</u>	9
Item 2. <u>Properties</u>	22
Item 3. <u>Legal Proceedings</u>	22
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	24
Item 4.5 <u>Executive Officers of the Registrant</u>	24
<u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	26
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 8. <u>Financial Statements and Supplementary Data</u>	34
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	34
Item 9A(T). <u>Controls and Procedures</u>	34
Item 9B. <u>Other Information</u>	35
<u>PART III</u>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	36
Item 11. <u>Executive Compensation</u>	36
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	36
Item 13. <u>Certain Relationships and Related Transactions and Director Independence</u>	36
Item 14. <u>Principal Accountant Fees and Services</u>	36
<u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	36
<u>Signatures</u>	

Table of Contents

PART I

Note Regarding Forward-Looking Statements

Tri-S Security Corporation, a Georgia corporation (Tri-S, the Company or we), has made forward-looking statements in this Annual Report on Form 10-K for the year ended December 31, 2008 (the Annual Report), including, without limitation, in the sections herein titled Management s Discussion and Analysis of Financial Condition and Results of Operations and Business, that are based on our management s beliefs and assumptions and on information currently available to our management. Forward-looking statements include information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts. Words such as believes, expects, anticipates, intends, seeks, could, will, predicts, potential, continue, may, plans, estimates the negative of these and similar expressions, are intended to identify such forward-looking statements.

Forward-looking statements are based on factors that involve risks, uncertainties and assumptions, and actual results may differ from those expressed or implied by the forward-looking statements. These factors include, among others: the legal claims pending or threatened against us; the cost of defending such claims; the consequences to us if we do not prevail on such claims; our substantial debt and our inability to make scheduled debt service payments; our dependence on our credit facility; the restrictions imposed on us by the credit agreement with our lenders; the impact of terrorist activity or breach of security on our business; our ability to retain and manage our guards; our plans for expansion and growth of our business; our ability to compete effectively in our industry; our expectations regarding the likelihood of introduction of new regulations that would adversely affect our business; our estimated capital requirements and needs for additional financing; risks related to Federal government contracts; Federal government audits and cost adjustments; differences between authorized amounts and amounts received by us under Federal government contracts; changes in Federal government (or other applicable) procurement laws, regulations, policies and budgets; our ability to retain contracts during re-bidding processes; and the other factors that we describe in this Annual Report under the sections herein titled Management s Discussion and Analysis of Financial Condition and Results of Operations, Business and Risk Factors. You should not put undue reliance on any forward-looking statement. You should understand that many important factors, in addition to those discussed in the sections herein titled Management s Discussion and Analysis of Financial Condition and Results of Operations, Business, Risk Factors and elsewhere in this Annual Report, could cause our results to differ materially from those expressed in forward-looking statements.

All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth in this Annual Report. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update publicly any of these statements in light of new information or future events.

Item 1. Business Overview

Through our two direct, wholly-owned subsidiaries, Paragon Systems, Inc. (Paragon Systems) and The Cornwall Group, Inc. (Cornwall), we provide equipment and security services to various government agencies and the private sector. Our government customers include local, state and Federal government agencies. Our private sector customers include commercial customers, such as universities, public school systems, corporate complexes, hospitals, and residential customers, such as condominiums, high-end apartments and high-security homes.

We strive to provide cost-effective solutions to ensure the safety and security of the assets and personnel of our customers and to continually improve the protection we provide for their personnel, programs, resources and facilities. Our goal is to provide demonstrably superior contract guard services with the highest degree of integrity and responsiveness.

Tri-S was incorporated in Georgia in October 2001 under the name Diversified Security Corporation and changed its name to Tri-S Security Corporation in August 2004. We were formed for the purpose of acquiring and consolidating electronic and physical security companies in order to take advantage of the operating efficiencies created by a larger

Table of Contents

company. Our acquisition strategy involves the acquisition and integration of complementary businesses in order to increase our scale within certain geographic areas and capture market share in the markets in which we operate and improve our profitability. We may pursue acquisition opportunities in the contract guard services and system integration services segments of the security industry. We frequently evaluate acquisition opportunities and, at any given time, may be in various stages of due diligence or preliminary discussions with respect to a number of potential acquisitions. From time to time, we may enter into non-binding letters of intent, but we are not currently subject to any definitive agreement with respect to any acquisition material to our operations or otherwise so far advanced in any discussions as to make an acquisition material to our operations reasonably certain. During 2006, 2007 and 2008, we did not pursue acquisitions because we were focused on the integration of the companies previously acquired. In the future, we plan to resume our acquisition plan if opportunities are available.

History

We made our first acquisition on February 27, 2004, when we acquired all of the outstanding capital stock of Paragon Systems, a contract guard services and logistics provider for a purchase price of \$16,000,000 (the Paragon Acquisition). At the closing of the Paragon Acquisition, we: (i) paid \$10 million, of which \$2.3 million was paid in cash and \$7.7 million was paid through issuance of promissory notes to the former shareholders of Paragon Systems (the Selling Shareholders); and (ii) issued to the Selling Shareholders an aggregate of 100 shares of our Series C Redeemable Preferred Stock, with an aggregate redemption value of \$6.0 million (the Series C Redeemable Preferred Stock), payable no later than February 27, 2007. Our payment obligations under the Series C Redeemable Preferred Stock were secured by a pledge of 40% of the outstanding capital stock of Paragon Systems. On February 27, 2006, we filed a lawsuit against the Selling Shareholders alleging, among other things, that they breached certain representations made by them in the Stock Purchase Agreement between us and them dated as of February 23, 2004, pursuant to which we acquired Paragon Systems. On September 13, 2007, we entered into a Settlement Agreement (the Paragon Settlement Agreement) among Tri-S, Paragon Systems and Ronald G. Farrell, our Chief Executive Officer, and the Selling Shareholders to settle all of the litigation pending among such parties (the Litigation). Pursuant to the Settlement Agreement, among other things, (a) the shares of the Series C Redeemable Preferred Stock held by the Selling Shareholders, which shares had an aggregate redemption value of \$6,000,000, were cancelled; (b) the Selling Shareholders terminated and released their security interest in the outstanding shares of capital stock of Paragon Systems; and (c) we issued to the Selling Shareholders an aggregate of 100 shares of our Series D Redeemable Preferred Stock (the Series D Redeemable Preferred Stock), which have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012 or the date on which we sell 70% or more of our assets in one or more transactions (unless the proceeds from such sale are reinvested in our business, used to restructure debt or used for acquisitions or working capital purposes), accrue dividends of \$750 per share per annum and are payable quarterly.

On February 8, 2005, pursuant to an Exchange and Recapitalization Agreement, we effected an exchange and recapitalization of our outstanding common stock, Series A Convertible Preferred Stock and Series B Convertible Preferred Stock and rights to acquire our common stock. Pursuant to the Exchange and Recapitalization Agreement, all of our outstanding (i) common stock, Series A Convertible Preferred Stock and Series B Convertible Preferred Stock was exchanged for an aggregate of 1,200,000 shares of our common stock and (ii) rights to acquire our common stock were exchanged for rights to purchase an aggregate of 113,269 shares of our common stock.

On February 9, 2005, we commenced an initial public offering of 1,800,000 units (plus up to additional 270,000 units upon the exercise of the underwriters over-allotment option), with each unit consisting of one share of our common stock and a publicly-traded warrant to purchase one share of our common stock, at an initial offering price per unit of \$6.00. In connection with our initial public offering, our units commenced trading on The NASDAQ Capital Market under the symbol TRISU on February 9, 2005. Our initial public offering closed with respect to the initial 1,800,000 units on February 14, 2005 and with respect to the additional 270,000 units on March 17, 2005. Our units separated and ceased trading as units on April 9, 2005, and our common stock and publicly-traded warrants commenced trading on The NASDAQ Capital Market on April 11, 2005, under the symbols TRIS and TRISW, respectively.

We made our second acquisition on October 18, 2005, when we acquired all of the outstanding capital stock of Cornwall, a provider of security and investigative services, including armed and unarmed uniform guards, video and alarm monitoring, alarm installation, and GPS monitoring, to government and private sector customers in the Miami, Florida area (the Cornwall Acquisition). Cornwall has eight wholly-owned subsidiaries: International Monitoring, Inc.; Protection Technologies Corporation; Vanguard Security, Inc.; Armor Security, Inc.; Forestville Corporation; Vanguard

Table of Contents

of Broward County, Inc.; On Guard Security and Investigations, Inc. and Guardsource Corp. At the closing of the Cornwall Acquisition, we paid a total purchase price of \$13,500,000 payable as follows: (i) payment of \$12,825,000 in cash; (ii) delivery of a promissory note in principal amount of \$250,000 payable to the former Cornwall shareholders (the Cornwall Promissory Note); and (iii) deposit of \$425,000 with an escrow agent to secure the indemnification obligations of the former Cornwall shareholders under the Stock Purchase Agreement between us and the former Cornwall shareholders dated as of August 11, 2005 (the Cornwall Purchase Agreement). After adjusting for certain working capital items, the net purchase price was \$12,753,000. On January 26, 2007, we entered into a Settlement Agreement and General Release (the

Cornwall Settlement Agreement) with David Shopay, on behalf of himself and the other former shareholders of Cornwall, in his capacity as the representative of such shareholders. Pursuant to the Cornwall Settlement Agreement: (a) the parties waived and released each other from all claims and liabilities, with the exception of certain claims and liabilities specified in the Cornwall Settlement Agreement, arising from the Cornwall Purchase Agreement; (b) the shareholder representative forgave and discharged all amounts owed by us to the former shareholders of Cornwall under the Cornwall Promissory Note; and (c) the shareholder representative and the Company instructed the escrow agent administering the escrow fund to release \$200,000 from such fund to us and the remaining balance of such fund to the former shareholders of Cornwall.

In March 2006, Paragon Systems formed Southeastern Paragon (SEP), a joint venture between Paragon Systems and Southeastern Protective Services, Inc. SEP has been certified by the U.S. Small Business Administration (the SBA) as a small and disadvantaged business (an 8(a) firm) and is therefore qualified to bid on security contracts specially designated for 8(a) firms. Paragon Systems owns 49% of SEP and is the manager of the SEP business.

In September 2007, Paragon Systems formed On Duty Patrol Services LLC (ODPS), a joint venture between Paragon Systems and On Duty Patrol Services, Inc. ODPS has been certified by the SBA as an 8(a) firm and is therefore qualified to bid on security contracts specially designated for 8(a) firms. Paragon Systems owns 49% of ODPS.

Our principal executive offices are located at Royal Centre One, 11675 Great Oaks Way, Suite 120, Alpharetta, Georgia 30022. Our telephone number at that address is (678) 808-1540.

Our Contract Guard Services Operations

Through Paragon Systems and Cornwall, we provide equipment and security services to various government agencies and the private sector. Our services include providing uniformed and armed guards for access control, plant security, personnel security, theft prevention, surveillance, vehicular and foot patrol, crowd control and the prevention of sabotage, terrorist and criminal activities. We provide guards and other personnel who are, depending on the particular requirements of the customer, uniformed or plain-clothed, armed or unarmed, and who patrol in marked radio cars or stand duty on the premises at stationary posts. Our guards maintain contact with headquarters or supervisors via car radio or hand-held radios. In addition, our guards respond to emergency situations and report to appropriate authorities for fires, natural disasters, work accidents and medical crises.

In connection with providing these services, we assume responsibility for a variety of functions, including recruiting, hiring, training and supervising the guards deployed to the customers we serve, as well as paying all security guards and providing them with firearms, uniforms, fringe benefits, workers compensation insurance and any required bonding. We are responsible for preventing the interruption of guard services as a consequence of illness, vacations or resignations.

Paragon Systems

Paragon Systems was incorporated in 1987 in Alabama and has provided contract guard services to Federal government agencies since 1994. Initially, Paragon Systems was established as an engineering company to service contracts with the Federal government agencies and with the U.S. Army Missile Command in both space and defense related areas of business. Paragon Systems has participated in high level engineering projects for the U.S. Army, the National Aeronautics and Space Administration, other government agencies and local industry.

In 1991, Paragon Systems applied to be certified as an 8(a) firm by the SBA. In 1993, Paragon Systems was certified as an 8(a) firm and, in 1994, was awarded its first guard contract to provide security guard services for the U.S. Army Corps of Engineers. Since such time, Paragon Systems has obtained contracts with various other Federal government agencies and has developed contract guard security services as its core business. Paragon Systems certification as an

Table of Contents

8(a) firm expired in September 2002, and its revenues from its security guard service business have grown to a level which makes it ineligible to qualify once again for certification as an 8(a) firm. Paragon Systems is now expanding its security guard service business by bidding on larger contracts than it was first awarded when certified as an 8(a) firm.

In 1994, Paragon Systems applied its engineering expertise and management skills to the security industry. Paragon Systems was awarded its first contract in 1994 to provide security services for the U.S. Army Corps of Engineers. Since such time, Paragon Systems has obtained contracts with various other Federal government agencies and has provided high-level, expert security services. Paragon Systems has, through the utilization of its systems engineering skills, developed contract guard security services as its core business. Paragon Systems no longer provides engineering services.

Through Paragon Systems and SEP, we employ approximately 2,000 persons in the course of providing contract guard services and maintain field offices located in Maryland, Mississippi, Washington, Pennsylvania, New York, Georgia, Oregon, California, South Carolina and Washington, DC. A full staff supports the majority of field operations in Paragon Systems's Chantilly, Virginia office, including human resources, accounting, payroll, quality control, logistics, computer services, training, and other supporting functions as needed. Accounts payable support is now managed in Tri-S's headquarters in Alpharetta, Georgia.

The following table sets forth the number of our Federal government contracts serviced by Paragon Systems during the time periods and within the revenue ranges indicated:

Annual Revenues	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Less Than \$1.0 Million per Contract	1	4	8
\$1.0 to \$3.0 Million per Contract	9	7	4
Greater than \$3.0 Million per Contract	11	7	4

On December 31, 2008, 18 contracts were active. At December 31, 2008, SEP was serving two Federal contracts with aggregate annual contract revenue of approximately \$5.9 million.

Cornwall

The Cornwall Acquisition diversified our customer base and allowed us to enter the private sector of contract guard services, including commercial and residential outlets. Cornwall provides armed and unarmed uniformed security services.

Cornwall was incorporated in 1980 and today employs approximately 1,000 employees in four offices throughout the Miami-Dade, Broward and Palm Beach counties of Florida. Each of Cornwall's security professionals undergo extensive training, and many have prior military or government training.

Our Equity Interest in Army Fleet Support, LLC

Until May 2006, we owned, through Paragon Systems, a 10% equity interest in Army Fleet Support, LLC (Army Fleet Support) which provides all logistics support for U.S. Army aviation training at Fort Rucker, Alabama. In providing this support, Army Fleet Support provides personnel, management, material parts, supplies, transportation and equipment to perform aviation unit maintenance, aviation unit intermediate maintenance and approved depot maintenance.

During May 2006, we sold our 10% equity interest in Army Fleet Support for \$10.8 million cash.

Sales and Marketing

Our sales and marketing approach is designed to develop business with respect to government and private sector customers. Sales promotions are managed through the offices of our subsidiaries, Paragon Systems and Cornwall, located in the Washington DC area and Miami/Palm Beach area, respectively. Our key marketing vehicles are our website, trade and industry media publications, email marketing, Federal government bulletin board sites on the Internet, word of mouth, customer referrals and potentially direct marketing.

Table of Contents

Employees

As of December 31, 2008, we employed approximately 3,000 people, consisting of security guards, managerial and administrative employees. Our business is labor intensive and, as a result, is affected by the availability of qualified personnel and the cost of labor. Although the contract guard services industry is characterized by high turnover, we believe our experience compares favorably with that of the industry. We have not experienced any material difficulty in employing suitable numbers of qualified security guards, although when labor has been in short supply, we have been required to pay higher wages and incur overtime charges.

We believe that the quality of our security guards is essential to our ability to offer effective and reliable service, and we believe diligence in their selection and training produces the level of performance required to maintain customer satisfaction and internal growth. Our policy requires that all selected applicants for a security guard position with us undergo a detailed pre-employment interview and a background investigation covering such areas as employment, education, military service, medical history and, subject to applicable state laws and criminal record checks. Personnel are selected based upon physical fitness, maturity, experience, personality, stability and reliability. We treat all employees and applicants for employment without unlawful discrimination as to race, creed, color, national origin, sex, age, disability, marital status or sexual orientation in all employment-related decisions. However, all Federal guard service contracts require that guards be a minimum of 21 years of age.

Our comprehensive training programs for our security guards include pre-assignment training, on-the-job assignment training and refresher training. Pre-assignment training explains the duties and powers of a guard, report preparation, emergency procedures, ethics and professionalism, grounds for discharge, general orders, uniforms and personal appearance, and basic post responsibilities. It also includes jurisdiction and legal responsibilities, use of force, arrest authority and procedures, search and seizure procedures, crime scene protection, rules of evidence, hostage situations, bomb threats and incidents, workplace violence, sabotage and espionage, terrorism/anti-terrorism and weapons of mass destruction. On-the-job assignment training covers specific duties as required by the post and job orders. Ongoing refresher training is given on an annual basis as the need arises as determined by the local area supervisor and manager or quality control personnel.

Unionized employees account for approximately 59% of our employees and work under collective bargaining agreements with the United Union of Security Guards, United Government Security Officers of America, United Federation of Special Police & Security Officers, Association of Contract Employees, Security, Police and Detention Officers and the Security Police and Fire Professionals of America. These collective bargaining agreements do not permit work stoppages. Our relations with our employees have generally been satisfactory. Guards and other personnel supplied by us to its customers are our employees, even though they may be stationed regularly at the customer's premises.

Insurance

We maintain all appropriate forms of insurance, including comprehensive general liability, performance and crime bonding, professional liability and automobile coverage. Special coverage is sometimes added in response to unique customer requirements. We also maintain compliance with all state workers' compensation laws. A certificate of insurance, which meets individual contract specifications, is made available to every customer.

Customers

We provide contract guard services for the following Federal government agencies: (i) the Department of Homeland Security; (ii) the Social Security Administration; (iii) the National Park Service; and (iv) the Department of Defense. We also provide contract guard services to the following state and local government agencies and private sector organizations: (a) Miami-Dade local government (municipal government); (b) Florida Department of Transportation; (c) State of Florida; and (d) The University of Miami.

Our typical customer contract may provide for an hourly or monthly billing rate used for all security guards at a site or variable hourly billing rates for different guards. Our contracts are usually multi-year contracts with renewal options. For the year ended December 31, 2008, nine contracts represented approximately 90% of our revenues as follows:

Contract	Percentage of Revenue
Department of Homeland Security (DHS) (Southern California)	24%
Social Security Administration (SSA) (Baltimore)	19%

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

General Services Administration (GSA) (Miami-Dade County)	10%
DHS (Georgia)	9%
DHS (Nebraska Avenue Complex)	7%
DHS (Metro Washington)	7%
DHS (Northwest Washington)	6%
DHS (Oregon)	4%
SSA (Baltimore Metro)	4%

Table of Contents

Competition in Contract Guard Services

The contract guard services segment of the security industry is highly competitive but fragmented. Contract guard services generally compete with each other on price and the quality of service provided; the scope of the services performed; name recognition; the extent and quality of the guard supervision, recruiting, selection and training; and the ability to handle multiple worksites nationwide.

In the bidding process for our Federal government contracts, there may be 30 bidders or more. However, typically only five or six bidders have the technical qualifications as established by the government agency's request for proposal. In the bidding process for our private sector contracts, there are typically five to seven other bidders. In each bidding process, we compete primarily on price, the quality of our service and our history of providing contract guard services in the southeastern portion of the United States for over a decade.

Our largest competitors in the contract guard services market include contract security service providers such as Coastal International Security, Intercom, Wackenhut/Alletug, Securitas and Allied Barton. These competitors are much larger than we are and have significantly greater resources with which to target our markets, including name recognition. The guard industry also contains a large number of smaller regional and local security service providers in the United States, in addition to those listed above which also directly compete with us, including Alpha Protective Services, Inter-Con Security, Knight Protective Services, Inc., US Security Associates, MVM, Akal Security and Security Consultants Group.

We believe that we have highly skilled accounting and cost management personnel and an excellent reputation for providing services to our customers on time and within budget. These competitive advantages contribute to our ability to obtain contracts through the competitive bidding process and negotiated contracting. Another competitive advantage is our capability to leverage our field offices in conjunction with our two management offices and one corporate headquarters to maximize efficiency throughout our operations.

Because of the contract guard services industry's low barriers to entry, competitors easily enter the industry. Furthermore, traditional guard companies will increasingly compete with the electronics side of the security industry, as customers increase their level of automation and replace guards with more sophisticated electronic hardware.

Government Regulation

We are subject to city, county and state firearm and occupational licensing laws that apply to security guards and private investigators. In addition, many states have laws or regulations requiring training and registration of security guards, regulating the use of badges and uniforms, prescribing the use of identification cards or badges, and imposing minimum bond, surety or insurance standards. We may be subjected to penalties or fines as the result of licensing irregularities or the misconduct of one of our guards from time to time in the ordinary course of our business.

We are also subject to certain Federal regulations, including regulations concerning the use and distribution of firearms. Violations of these regulations may result in criminal penalties. Furthermore, we are subject to Federal laws and regulations relating to the formation, administration and performance of Federal government contracts, including the Federal Acquisition Regulations and supplemental GSA regulations, the Truth in Negotiations Act and the Cost Accounting Standards.

Table of Contents

The Security Industry

The security industry encompasses a variety of high-tech and low-tech products and services. The service segment of the security industry includes contract guard services, armored car services, executive protection, fire suppression, alarm monitoring, closed circuit television (CCTV), access control, biometric, home automation and system integration services.

The global security industry has grown largely due to an increasing fear of crime and terrorism. In the United States, the demand for security-related products and central station monitoring services also has grown steadily. We believe that there is continued heightened attention to and demand for security due to the events of September 11, 2001, and the ensuing threat, or perceived threat, of criminal and terrorist activities.

Despite the size and prospects for growth of the services segment of the security industry, the services segment, including the contract guard services and system integration services, remains highly fragmented. We believe this high degree of fragmentation in the security industry makes it a prime candidate for future consolidation.

The contract guard services segment of the security industry includes security and patrol services, as well as various types of investigation services, including background, undercover, insurance claims and financial fraud. Contract guard services are provided under contracts in which the guard company agrees to recruit, hire, train, supervise, schedule and pay security guards deployed to certain specified sites, as well as to provide firearms, uniforms and equipment. Typical functions for security guards include patrolling the premises, checking identification for access control, staffing a security control center, monitoring activities on CCTV, and responding to emergency requests for assistance. Contract guard services are customarily charged to the customer at an hourly or monthly rate (which can be fixed or variable). A contract guard company's profit is based on the spread of the hourly or monthly rate over the cost of the guard.

Demand for guard services is dependent upon a number of factors, including demographic trends, general economic variables such as growth in the gross domestic product, unemployment rates, consumer spending levels, perceived and actual crime rates, government legislation, terrorism sensitivity, war/external conflicts and technology.

Our Strategy

Operations

Our objective is to increase our revenues, profitability and market position, while maintaining the highest level of service to our customers. The key elements of our operations strategy include the following:

managing personnel costs by minimizing turnover through effective recruitment, training and supervision of guards;

retaining existing customers and engaging new customers by servicing clients with the highest degree of integrity and responsiveness;

developing cost-effective solutions for the security needs of our customers;

capitalizing on the growing trend among businesses and Federal government agencies to outsource non-core functions such as security officer services; and

developing our consolidated operating infrastructure for all acquired companies' accounts payable to leverage larger company efficiencies.

Federal Government Contracts

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Typically, a service provider is awarded a multi-year contract through a Federal government facility with renewal options each year of the contract in order to comport with Congressional funding as well as performance reviews. With our standard Federal government contracts, we are awarded a multi-year contract, an extension for each of the subsequent years of the contract and the opportunity to bid for the overall contract renewal.

Table of Contents

A significant number of our current contracts for contract guard services were awarded by the Federal government through a competitive bid process. We intend to grow our business by obtaining new Federal government contracts through the competitive bidding process and by providing additional services under our current Federal government contracts.

The Federal government awards substantially all contracts for contract guard services through a competitive bidding process; however, certain agencies permit negotiated contracting through the GSA. Contracts awarded through a competitive bidding process generally have lower profit margins than negotiated contracts because in a competitive bidding process bidders compete predominantly on price. The Federal government is the largest procurer of products and services in the world, and the Federal contract market provides significant business opportunities for contract guard service providers approved to contract with the Federal government.

We have hired full-time employees to provide business development and marketing services for us. These job responsibilities focus on identifying new contract opportunities with Federal government agencies and preparing and submitting bids for such contracts.

We currently have bids outstanding on Federal government contracts for contract guard services valued at an aggregate amount of over \$24 million over the next five-years. In addition, we have been solicited to bid on contracts valued at an aggregate amount of approximately \$530 million over the next five years. Our ability to bid on larger contracts is constrained because we do not currently have sufficient capital to cover the substantial start-up costs we would incur if awarded a significant number of contracts with higher values.

Private Sector Contracts

Private sector contracts are awarded through a competitive bidding process and through a negotiating process. Unlike the Federal government contracts, the terms of private sector contracts can vary based on individual client situations. Price is not the only key element in winning contracts with this market segment. Other elements such as service quality, responsiveness and various peripheral offerings other than traditional guard services come into consideration. We believe that the private sector represents our largest growth potential.

The private sector customers, however, generally do not obtain contract guard services through a competitive bid process, but privately negotiate contracts for such services, resulting in contracts with higher profit margins because price is not always the primary basis for competition. The private sector provides an opportunity for contract guard service providers to grow through acquisitions.

As a result of the Cornwall Acquisition, we obtained a number of contracts for commercial and residential customers. We intend to expand our business in the private sector by bidding and negotiating contracts for guard services for commercial and residential customers.

We have dedicated employees to provide business development and proposal submissions for us. Job responsibilities of these individuals focus on identifying new bidding opportunities, bid proposal development and competitive negotiations.

We intend to continually bid on private sector contracts for guard services.

Acquisitions

We intend to develop and expand our business by selectively pursuing acquisition opportunities in the contract guard services and system integration services segments of the security industry. We intend to target for acquisition existing companies with established reputations for quality customer service.

In the contract guard services market, we seek to acquire organizations which provide contract guard services to the private sector. We are also looking to acquire organizations which provide contract guard services to the private sector, including residential and commercial facilities, and which have contracts with higher profit margins than our current Federal government contracts. Although we intend our initial acquisition activities to be concentrated in the Southeast, Midwest and Atlantic coastal portions of the United States, we have not placed any geographic restrictions on our future acquisition strategy. We believe we will have significantly more acquisition possibilities in the private sector than in the Federal government sector.

Table of Contents

We frequently evaluate acquisition opportunities and, at any given time, may be in various stages of due diligence or preliminary discussions with respect to a number of potential acquisitions. From time to time, we may enter into non-binding letters of intent, but we are not currently subject to any definitive agreement with respect to any acquisition material to our operations or otherwise so far advanced in any discussions as to make an acquisition material to our operations reasonably certain.

Because the security industry is still very highly fragmented, we believe there will be no lack of opportunities for acquiring the type of companies that are the focus of our planned acquisition efforts. Both industry segments are marked by concentration by several of the well known larger providers of security services, such as Allied Barton., Securitas Security Services USA and Rentokil Initial plc. While there is concentration among the larger providers, we believe there remains a number of quality, sizable regional and local providers that are available for acquisition.

Item 1A. Risk Factors
Risks Relating to Our Indebtedness

If we are in default under our Amended and Restated Credit Agreement or any agreement we have with our lenders, then all amounts due there under will become immediately due and payable, which will have a material adverse effect on our business and financial condition.

On December 31, 2007, we entered into an Amended and Restated Credit Agreement, as may be amended from time to time (the Amended and Restated Credit Agreement), with LSQ Funding Group, L.C. (LSQ) and BRE LLC (BRE and, together with LSQ, our Lenders), which amends and restates the Credit Agreement between us and our Lenders dated as of October 19, 2005, as amended from time to time (the Original Credit Agreement). The Amended and Restated Credit Agreement amends and restates the Original Credit Agreement to provide us with a revolving, asset-based lending facility with up to \$25.0 million of borrowing availability, replacing our pre-existing factoring facility with up to \$12.0 million of borrowing availability under the Original Credit Agreement. In connection with entering into the Amended and Restated Credit Agreement, we also entered into: (i) a Loan and Security Agreement with LSQ, as may be amended from time to time (the Loan and Security Agreement); and (ii) a Supplemental Agreement to Amended and Restated Credit Agreement with our Lenders, as may be amended from time to time (the Credit Agreement Supplement).

The Amended and Restated Credit Agreement continues to provide for the \$2,500,000 term loan to us (the 2007 Term Loan) contemplated by the Original Credit Agreement. Under the Amended and Restated Credit Agreement, interest on the 2007 Term Loan accrues at a rate equal to the prime rate, as published by the Wall Street Journal from time to time (the Prime Rate), plus 4.50% (the Non-Default Rate), but at no time shall the interest rate be less than 11.25% per annum. If an event of default under the Amended and Restated Credit Agreement occurs, then interest accrues on the 2007 Term Loan at a rate equal to the Non-Default Rate plus 5% and certain other default fees specified in the Amended and Restated Credit Agreement would become due and payable.

Pursuant to the Loan and Security Agreement, at our request, LSQ shall make advances (Advances) to us not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable through March 31, 2009 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of: (i) billed accounts receivable at a rate equal to the Prime Rate plus 1% (but not less than 11%); and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5% (but not less than 12%). In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%.

Under the Credit Agreement Supplement, anytime the 2007 Term Loan is outstanding and so long as unbilled accounts receivable are included in the borrowing base for purposes of making Advances, we must pay a monthly overadvance monthly to our Lenders equal to: (i) 2.25% of the highest daily overadvance amount (which is the highest

Table of Contents

daily amount in any given month calculated as the outstanding 2007 Term Loan plus all outstanding Advances less the borrowing base) less (ii) \$60,000 or such lesser amount as will reduce the overadvance fee to zero. In addition, the Credit Agreement Supplement requires that we issue to our Lenders a four-year warrant to purchase 30,000 shares of our common stock, at an exercise price of \$3.00 per share, for each month in which an overadvance under the Loan and Security Agreement exists. In no event shall such warrants issued to Lenders under the Credit Agreement Supplement be exercisable in the aggregate for greater than 420,000 shares of our common stock.

All of our obligations under the Amended and Restated Credit Agreement and the Loan and Security Agreement are secured by a first priority security interest in all of our assets and a pledge of all of the equity interests in our subsidiaries.

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2008, is approximately \$20.2 million. Additionally, from time to time during 2008, we have borrowed more than the maximum amount allowable under the availability formula under the Amended and Restated Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2008, we were not in compliance with the Amended and Restated Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, we entered into an Amendment and Forbearance Agreement, as amended from time to time (the Forbearance Agreement), with our Lenders. Pursuant to the Forbearance Agreement, our Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forebear from exercising all remedies available to them in connection with such existing defaults until the earlier of (i) a potential equity or subordinated debt offering by us or (ii) January 1, 2009. On December 12, 2008, the Forbearance Agreement was amended to extend the end of the forbearance period from January 1, 2009 to January 1, 2010.

If an event of default under the Amended and Restated Credit Agreement or any agreement we have with our Lenders occurs, then the entire balance outstanding under all such agreements shall become immediately due and payable. We will not be able to repay this balance unless we raise significant capital by selling assets or issuing debt or equity securities, which we may not be able to do on terms acceptable to us, if at all. If the balance outstanding under our agreements with our Lenders becomes immediately due and payable and we are unable to raise significant capital or obtain from our Lenders an additional waiver and an agreement to forbear, then we will not be able to satisfy our obligations to our Lenders, they may proceed to foreclose on the collateral and our business and financial condition will be materially and adversely affected.

If our Lenders stop advancing funds to us under the Amended and Restated Credit Agreement, then we may not be able to satisfy our current operating payables, which would have a material adverse impact on our business and financial condition.

We rely on Advances under the Loan and Security Agreement and borrowings under the 2007 Term Loan for funds to satisfy our cash flow needs for our daily operations. Our Lenders are not obligated to advance additional funds to us under the Loan and Security Agreement or the 2007 Term Loan if the funds advanced to us and outstanding under the Loan and Security Agreement exceed our maximum availability or if we are otherwise in default under our agreements with our Lenders. If our Lenders stop advancing funds to us under the Loan and Security Agreement or do not allow us to borrow under the 2007 Term Loan, then we may not be able to satisfy our current operating payables, which would make it difficult for us to satisfy our contractual obligations to our customers. If we are not able to satisfy our current operating payables or our contractual obligations to our customers, then our business and financial condition will be materially and adversely affected. Further, our Lenders will not be obligated to advance additional funds to us under the Loan and Security Agreement until we reduce the amount of the advances outstanding under the Amended and Restated Credit Agreement to an amount which is less than our maximum availability. We may not be able to do so unless we raise significant capital by selling assets or issuing debt or equity securities, which we may not be able to do on terms acceptable to us, if at all.

We have substantial debt.

As of December 31, 2008, we had approximately \$31.9 million of outstanding debt (excluding obligations to trade creditors and taxing authorities, including the IRS). We may incur substantial additional debt in the future, including

Table of Contents

additional debt under the Loan and Security Agreement. It will be difficult for us to satisfy our payment obligations as currently scheduled. Our considerable indebtedness could have important consequences to you, including, but not limited to, the following:

our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes may be impaired;

we are exposed to fluctuations in interest rates because Advances under the Loan and Security Agreement and the 2007 Term Loan have variable rates of interest;

we may have more debt than some of our competitors, which may put us at a competitive disadvantage and reduce our flexibility in planning for, or responding to, changing conditions in our industry, including increased competition; and

we are more vulnerable to general economic downturns and adverse developments in our business.

We may not be able to generate sufficient cash to service all of our indebtedness, and we may be forced to take other actions to satisfy our payment obligations, which actions may not be successful.

Our ability to make scheduled debt service depends on our financial and operating performance, which is subject to prevailing economic and competitive industry conditions and to certain financial, business and other factors beyond our control. These factors include, but are not limited to:

interest rates and general economic conditions;

competitive conditions in our industry;

operating difficulties, operating costs or pricing pressures that we may experience;

passage of legislation or other regulatory developments that affect us adversely; and

delays or difficulties in implementing our business strategies.

We cannot assure you that we will maintain a level of cash flows from operating activities sufficient to permit us to make our scheduled debt service payments or otherwise satisfy our indebtedness. If our cash flows and capital resources are insufficient to fund our debt service obligations, then we may be forced to reduce or delay capital expenditures, seek additional capital, sell assets or restructure or refinance our indebtedness. These alternative measures may not be successful and may not permit us to meet our scheduled debt service payments. If our cash flows and capital resources are insufficient to fund our debt service obligations, then we could face substantial liquidity problems and might be required to scale back our operations or dispose of material assets to meet our debt service obligations. The Amended and Restated Credit Agreement restricts our ability to dispose of our assets and requires that all proceeds from any such disposition be used to reduce our obligations to our Lenders. Even if we are able to dispose of certain assets, we may not be able to make such dispositions at prices that we believe are fair or use the proceeds from such dispositions to make payments on our indebtedness, other than indebtedness to our Lenders.

The Amended and Restated Credit Agreement imposes significant restrictions on us, which may prevent us from capitalizing on business opportunities and taking certain corporate actions.

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

The Amended and Restated Credit Agreement imposes significant operating and financial restrictions on us. These restrictions limit our ability to:

incur or guarantee additional indebtedness;

pay dividends and make distributions;

make certain investments;

Table of Contents

repurchase stock;

incur liens;

enter into certain transactions with affiliates;

enter into sale and leaseback transactions;

merge or consolidate; and

transfer or sell assets.

These covenants may adversely affect our ability to finance our future operations or capital needs, pursue available business opportunities or take certain corporate actions.

If we are unable to satisfy or otherwise settle our indebtedness, then we may lose control of our subsidiaries, which generate all of our revenue.

We have granted to our Lenders a security interest in all of the capital stock of all of our subsidiaries to secure our obligations to our Lenders. If we are in default under the Amended and Restated Credit Agreement, the Loan and Security Agreement or any other agreement with our Lenders, then our Lenders could foreclose on such stock. If our Lenders foreclose on the stock pledged to them, then we will lose all of our revenue, and our business and financial condition will be materially and adversely affected.

Risks Relating to Our Securities

Our securities may be delisted from the NASDAQ Capital Market.

Our common stock and the warrants we issued in our initial public offering are currently listed for trading on the NASDAQ Capital Market. We must satisfy certain minimum listing maintenance requirements to maintain such listing, including a series of financial tests relating to shareholders' equity or net income or market value, public float, number of market makers and shareholders, and maintaining a minimum bid price for our common stock.

On August 20, 2008, The NASDAQ Stock Market LLC (the "NASDAQ") notified us that we no longer satisfy the minimum \$2.5 million shareholders' equity requirement for continued listing on the NASDAQ Capital Market, as required by the NASDAQ Marketplace Rule 4310(c)(3) (the "Rule"). As requested by the NASDAQ staff, we provided the NASDAQ on September 4, 2008, with a plan (the "Compliance Plan") to achieve and sustain compliance with all requirements of continued listing on the NASDAQ Capital Market, including the time frame for completion of the Compliance Plan. Based on its review of the Compliance Plan, the NASDAQ granted our request for an extension until December 3, 2008, to regain compliance with the Rule.

On December 4, 2008, we received a determination letter from the NASDAQ stating that: (i) upon further review, the NASDAQ staff determined that we did not meet the terms of the extension, including that we had not regained compliance with the Rule by December 3, 2008; and (ii) trading of our securities on the NASDAQ Capital Market would be suspended at the opening of business on December 15, 2008, and a Form 25-NSE would be filed with the SEC to remove our securities from listing and registration on the NASDAQ, unless we requested an appeal of the NASDAQ's determination. We requested such appeal by requesting a hearing with a NASDAQ Listing Qualifications Panel (the "Panel"). The hearing was held on January 29, 2009. The delisting of our securities has been stayed pending the Panel's decision. We can provide no assurance that our request for continued listing on the NASDAQ Capital Market will be granted by the Panel.

If our securities are delisted from the NASDAQ Capital Market, then our securities may trade on the Over-the-Counter-Bulletin Board, which is viewed by most investors as a less desirable and less liquid marketplace. Delisting from the NASDAQ Capital Market could make trading our securities more difficult for our investors, leading to declines in share price. Delisting of our securities may also make it more difficult and

expensive for us to raise additional capital.

Table of Contents

Management beneficially owns a significant percentage of our common stock and has the ability to influence all matters requiring the approval of our board of directors and our shareholders.

Management owns or controls shares of our common stock which shares represent approximately 36% of the combined voting power of our outstanding capital stock. Management has the power to influence the election of our directors and all decisions made by our shareholders and, in general, to influence the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets. The interests of management may conflict with the interests of our other shareholders.

Provisions of our Articles of Incorporation and Georgia law may have anti-takeover effects that could prevent a change in control which the shareholders consider favorable and could negatively affect your investment.

Provisions in our Articles of Incorporation and our Bylaws could delay or prevent a change of control of Tri-S or a change in our management that would provide shareholders with a premium to the market price of their common stock. Our Articles of Incorporation currently authorize the issuance of 10,000,000 shares of our preferred stock. Our board of directors has the power to issue any or all of these additional shares without shareholder approval, and such shares can be issued with such rights, preferences and limitations as may be determined by our board of directors. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of any holders of preferred stock that may be issued in the future. We presently have no commitments or contracts to issue any shares of preferred stock. Authorized and unissued preferred stock could delay, discourage, hinder or preclude an unsolicited acquisition of Tri-S, could make it less likely that shareholders receive a premium for their shares as a result of any such attempt and could adversely affect the market price of, and the voting and other rights, of the holders of outstanding shares of common stock. Currently, we have outstanding 100 shares of our Series D Redeemable Preferred Stock. Our Articles of Incorporation and Bylaws also contain provisions that:

create a classified board of directors that prevents a majority of the board from being elected at one time;

prohibit cumulative voting in the election of directors, which would otherwise allow less than a majority of shareholders to elect director candidates;

limit the ability of shareholders to call special meetings of shareholders; and

establish advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings.

We may experience significant volatility in the price of our common stock even if our business is doing well, which could cause you to lose all or part of your investment.

The stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. The market price of our common stock may also fluctuate as a result of variations in our operating results. Due to the nature of our business, the market price of our common stock may fall in response to a number of factors, some of which are beyond our control, including:

delisting of our securities from the NASDAQ Capital Market;

announcements of competitive developments by us or others;

changes in estimates of our financial performance or changes in recommendations by securities analysts;

any loss by us of a major customer;

additions or departures of key management or other personnel;

our failure to meet financial analysts' performance expectations;

Table of Contents

guidance we provide;

future sales of our common stock or preferred stock;

volume fluctuations;

acquisitions or strategic alliances by us or our competitors;

our historical and anticipated operating results;

quarterly fluctuations in our financial and operating results;

changes in market valuations of other companies that operate in our business markets or in our industry; and

general market and economic conditions.

Accordingly, market fluctuations, as well as general economic, political and market conditions such as recessions and interest rate changes, may negatively impact the market price of our common stock, and you may not be able to sell your shares without incurring a loss.

We do not intend to pay dividends on our common stock, and you may not experience a return on investment without selling your securities.

We have never declared or paid, nor do we intend in the foreseeable future to declare or pay, any cash dividends on our common stock. Because we intend to retain all future earnings to finance the operation and growth of our business, you will likely need to sell your shares in order to realize a return on your investment, if any. Further, the Amended and Restated Credit Agreement restricts our ability to pay dividends on our capital stock.

Risks Relating to Our Industry and Business

We depend on the Loan and Security Agreement to meet our cash flow needs, which reduces our profit margin.

Pursuant to the Loan and Security Agreement, our Lenders shall make Advances not to exceed \$25,000,000, which is subject to a borrowing base of 90% of accounts receivable, including unbilled accounts receivable through March 31, 2009 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of: (i) billed accounts receivable at a rate equal to the Prime Rate plus 1.0% (but not less than 11%); and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5% (but not less than 12%). In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%. This discount and usage fee reduces our profit margins. We cannot, however, cease financing our receivables because the funds provided by our Lenders are necessary to satisfy our cash flow needs. In fact, we utilize the Loan and Security Agreement to allow us to finance substantially all of our accounts receivable. We believe that if the Loan and Security Agreement with our Lenders were to terminate, then we would need to obtain a new credit agreement. Our obligations to our Lenders are secured by a lien on all of our assets; consequently, if we are liquidated, then there may not be any assets available for distribution to shareholders or creditors other than our Lenders.

Our service contracts often provide for fixed hourly bill rates or permit limited fee adjustments, and our business, financial condition and results of operations will be materially and adversely affected if increases in our costs cannot be charged to our customers.

Our largest expenses are payroll, payroll taxes and employee related benefits. Most of our service contracts provide for a fixed hourly bill rate, and some of our service contracts provide for payments of either fixed fees or fees that increase by only small amounts during the terms of such

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

service contracts or not at all. Competitive pressures also may prevent us from raising our fees or hourly bill rates when contracts are renewed. If, due to inflation or other causes, including

Table of Contents

increases in statutory payroll taxes, we must increase the wages, salaries and related taxes and benefits of our employees at rates faster than we can increase the fees charged under our service contracts, then our profitability will be adversely affected.

If we lose our executive officers or operation employees, our operations could be materially and adversely affected.

Our success is dependent to a significant extent upon the continuing efforts, abilities and business generation capabilities of our executive officers and senior operation employees. We have programs in place to motivate, reward and retain our executive officers and senior operation employees, including cash bonus and equity incentive plans. However, the loss or unavailability of any of our executive officers or senior operation employees could harm our ability to properly service or retain existing clients or operate new businesses. Our success and plans for future growth will also depend on our ability to hire and retain our executive officers and senior operation employees.

If we are unable to attract, retain and manage security guards and administrative staff, then our business, financial condition and results of operation will be materially affected.

Our business involves the labor-intensive delivery of contract security services. We derive our revenues largely from contract security guard services performed by our security guards. Our future performance depends in large part upon our ability to attract, develop, motivate and retain skilled security guards and administrative staff. Qualified security guards and administrative staff are in demand, particularly after the terrorist activity of September 11, 2001, and there is significant competition for these individuals from other security firms, government agencies and other similar enterprises. As a result, we may not be able to attract and retain sufficient numbers of these qualified individuals in the future, which may adversely affect our business.

Turnover of contract security guards is significant. The loss of the services of, or the failure to recruit, a significant number of skilled security guards and administrative staff would have a materially adverse affect on our business, financial condition and results of operations, including our ability to secure and complete service contracts. Furthermore, if we do not successfully manage our existing security guards and administrative staff, we may not be able to achieve the anticipated billing rates, engagement quality, level of overtime and other performance measures that are important to our business, financial condition and results of operations.

Organized labor action or occupational health and safety laws and regulations could have a material adverse effect on our business, financial condition and results of operations.

Our industry has been the subject of campaigns to increase the number of unionized employees. Although we believe that our relationships with our employees are good, we cannot provide you with any assurances that organized labor action at one or more of our facilities will not occur, or that any such activities, or any other labor difficulties at our facilities or the facilities of any of our customers, would not materially affect our business, financial condition and results of operations.

In addition, we are subject to, among other laws and regulations, comprehensive U.S. occupational health and safety laws and regulations. Such laws and regulations may become more stringent and result in necessary modifications to our current practices and facilities that could force us to incur additional costs that could materially affect our business, financial conditions and results of operations.

If we cannot successfully compete with new or existing security service providers, then our business, results of operations and financial condition will be adversely affected.

The contract security guard services industry is intensely competitive. We directly compete with companies that are national and international in scope, and some of our competitors have significantly greater personnel, financial, technical and marketing resources than we do, generate greater revenues than we do and have greater name recognition than we do. The recent trend toward consolidation in our industry will likely lead to increased competition from these companies. We also compete with smaller local and regional companies that may have better knowledge of the local conditions in their regions, are better known locally and are better able to gain customers in their regions. There are relatively low barriers to entry into the contract security guard services industry, and we have faced and expect to continue to face additional competition from new entrants into the contract security guard services industry. In addition, some of our competitors may

Table of Contents

be willing to provide services at lower prices, accept a lower profit margin or expend more capital in order to obtain or retain business. If we cannot successfully compete with new or existing security service providers, then our business, financial condition and results of operations will be adversely affected.

In the Federal government security services sector, we have experienced compressed margins for our services on new contracts relative to the margins earned on older contracts. We expect that future contract wins will be at profit levels which are lower than our current contract base due to increased competition for these contracts.

Changes in available security technology may have an adverse effect on our business, results of operations and financial condition.

Our business involves the labor intensive delivery of contract security services performed by our security guards. Changes in technologies that provide alternatives to security guard services or that decrease the number of security guards required to effectively perform their services may decrease our customers' demand for our security guard services. In addition, if such technologies become available for use in the industry, these technologies may be proprietary in nature and not be available for use by us in servicing our customers. Even if these technologies are available for use by us, we may not be able to successfully integrate such technologies into our business model or may be less successful in doing so than our competitors or new entrants in the industry. A decrease in demand for our security guard services or our inability to effectively utilize such technologies may adversely affect our business, financial condition and results of operations.

The security services we provide may subject us to liability for substantial damages not covered by insurance which could have a material adverse effect on our business, financial condition and results of operations.

We provide security services at various customer locations. We may be held liable for the negligent acts or misconduct of our security guards or other employees performed while on duty and in the course and scope of their employment. We experience a significant volume of claims and litigation asserting that we are liable for damages as a result of the conduct of our security guards or other employees. We may from time to time be subject to claims that our security guards have physically or emotionally harmed individuals in the course of providing these services, or members of the public may be otherwise injured by events occurring on client premises, including events that are not under the immediate control of our security guards. Individuals may bring personal injury lawsuits against us seeking substantial damages based on alleged negligence or other theories of liability in our provision of security services, including with respect to injuries not directly caused by, or within the control of, our security guards. Under principles of common law, we can generally be held liable for wrongful acts or omissions to act of our agents or employees during the course, and within the scope, of their agency or employment with us.

In many cases, our security service contracts also require us to indemnify our clients or may otherwise subject us to additional liability for events occurring on client premises. In addition, some states have adopted statutes that make us responsible for the conduct of our agents and employees. While we maintain insurance programs that provide coverage for certain liability risks, including personal injury, death and property damage, the laws of many states limit or prohibit insurance coverage for punitive damages arising from willful or grossly negligent conduct. Consequently, insurance may not be adequate to cover all potential claims or damages. If a plaintiff brings a successful claim against us for punitive damages in excess of our insurance coverage, then we could incur substantial liabilities which would have a material adverse effect on our business, results of operations and financial condition.

Terrorist activity at locations where we provide security services could have a material adverse effect on our business by subjecting us to liability. Whether or not terrorist activity occurs at a client location, our insurance costs could increase, and we could be required to comply with more burdensome regulations.

If any locations where we provide security related services are attacked by terrorists, then liabilities resulting from such attacks may not be covered by insurance and could have a material adverse effect on our business, financial condition and results of operations by requiring us to incur additional personnel costs as a result of compliance with expanded security rules and regulations. In addition, terrorist attacks that do not directly involve locations serviced by us could have a material impact on us by increasing our insurance coverage costs or making insurance coverage unavailable altogether.

Table of Contents

We may be unable to obtain liability insurance at a reasonable cost, which would increase our exposure to catastrophic claims.

Insurance premiums have increased substantially since the terrorist attacks on September 11, 2001. If certain coverages are unavailable at premiums deemed reasonable by management, then our exposure for catastrophic claims would be increased.

We are subject to government regulation, and our failure or inability to comply with these regulations could materially restrict our operations and subject us to substantial penalties.

We are subject to a large number of city, county and state occupational licensing laws and regulations that apply to security guards. Most states have laws, or legislation pending, requiring qualification, training and registration of security guards, regulating the use of identification cards, badges and uniforms and imposing minimum bond surety or insurance standards. Any liability we may have from our failure to comply with these regulations may materially and adversely affect our business by restricting our operations and subjecting us to substantial penalties. In addition, our current and future operations may be subject to additional regulation as a result of, among other factors, new statutes and regulations and changes in the manner in which existing statutes and regulations are or may be interpreted.

We may not be successful in identifying suitable acquisition opportunities, and, if we do identify such opportunities, then we may not be able to obtain acceptable financing for the acquisition, reach agreeable terms with acquisition targets or successfully integrate acquired businesses.

An element of our growth strategy is the acquisition and integration of complementary businesses in order to increase our density within certain geographic areas, capture market share in the markets in which we operate and improve our profitability. We will not be able to acquire other businesses if we cannot identify suitable acquisition opportunities, obtain financing on acceptable terms or reach mutually agreeable terms with acquisition targets. In addition, to the extent that consolidation becomes more prevalent in our industry, the prices for suitable acquisition targets may increase to unacceptable levels thereby limiting our ability to grow.

Our growth through selective acquisitions may place significant demands on our management, operational and financial resources. Acquisitions involve numerous risks, including the diversion of our management's attention from other business concerns, the possibility that current operating and financial systems and controls may be inadequate to deal with our growth, and the potential loss of key employees.

We also may encounter difficulties in integrating any businesses we may acquire with our existing operations. The success of these transactions depends on our ability to:

successfully merge corporate cultures and operational and financial systems;

integrate and retain the customer base of the acquired business;

realize cost reduction synergies, including those cost reduction synergies that we expect to realize; and

as necessary, retain key management members and technical personnel of acquired companies.

If we fail to integrate acquired businesses successfully or to manage our growth, it could have a material adverse effect on our business. Further, we may be unable to maintain or enhance the profitability of any acquired business, consolidate its operations to achieve cost savings or maintain or renew any of its contracts.

In addition, there may be liabilities that we fail, or are unable, to discover in the course of performing due diligence investigations on any company that we may acquire, or have recently acquired. Also, there may be additional costs relating to acquisitions including, but not limited to, possible purchase price adjustments. Any of our rights to indemnification from sellers to us, even if obtained, may not be enforceable, collectible or sufficient in amount, scope or duration to fully offset the possible liabilities associated with the business or property acquired. Any such liabilities, individually or in the aggregate, could have a material adverse effect on our business.

Table of Contents

We may not have, or be able to obtain, sufficient capital to pursue our acquisition strategy.

Our acquisition strategy will require substantial capital. Such capital may be obtained by borrowings under credit facilities, through the issuance of long-term or short-term indebtedness or through the issuance of equity securities in private or public transactions. The Amended and Restated Credit Agreement restricts our ability to incur additional debt without the approval of our Lenders. If we are able to incur additional debt to pursue our acquisition strategy, then our interest expense will increase. Furthermore, we may not be able to obtain financing for future acquisitions on suitable terms, if at all.

In addition, executing our acquisition strategy may be more expensive than we anticipate because the purchase price for acquisition targets may increase due to mergers and other transactions recently completed in the security industry, and the growing interest in future mergers and consolidations. If the purchase price for acquisition targets we find appealing increases, then we will need more capital than we anticipate to execute our acquisition strategy, or we may not be able to execute our acquisition strategy at all.

We may not be able to obtain additional financing that may be necessary to fund our operations.

In order to fund our operations and increase revenues, additional financing may be required, which additional financing may not be available to us on commercially reasonable terms, if at all. We may not be successful in raising additional capital, and the proceeds of any future financings may not be sufficient to meet our future capital needs. We may need to seek additional financing sooner than we anticipate as a result of any of changes in operating plans, lower than anticipated sales or increased operating costs.

If our professional reputation is harmed, then we will have difficulty obtaining new customers and retaining existing customers, either of which would adversely affect our revenues.

We depend upon our reputation and the individual reputations of our senior professionals to obtain new customers and retain existing customers. Any factor that diminishes our reputation or the individual reputations of our senior professionals, including an ineffective response to terrorist activity or breach of security at any location we service, will make it more difficult for us to compete successfully for new customers or to retain existing customers and, therefore, would adversely affect our revenues.

Economic downturns or recessions may dampen the demand for our services, which will reduce our revenues.

During economic declines, some decisions to implement security programs and install systems may be deferred or cancelled. In other cases, customers may increase their purchases of security systems because they fear more inventory shrinkage and theft will occur due to increasing economic need. We are not able to accurately predict to what extent an economic slowdown will decrease the demand for our services. If demand for our services decreases, then our revenues will decline.

Risks Related to Government Contracting

We derive a significant portion of our revenue from Federal government contracts which the government may terminate at any time or decide not to extend after their scheduled expiration. If we are unable to replace any contract which is not extended or is terminated, then our revenues will decline.

During the year ended December 31, 2008, we derived approximately 74% of our consolidated revenue from contracts with the Federal government. Federal government contracts typically span one or more base years and one or more option years. The option periods may cover more than half of the contract's potential duration. Federal government agencies generally have the right not to exercise these option periods. In addition, our contracts typically also contain provisions permitting a government customer to terminate the contract for its convenience, as well as for our default. A decision by a government agency not to exercise option periods or to terminate contracts could result in significant revenue shortfalls.

If the government terminates a contract for convenience, then we may recover only our incurred or committed costs, settlement expenses and profit on work completed prior to the termination. We cannot recover anticipated profit on

Table of Contents

terminated work. If the government terminates a contract for default, then we may not recover even those amounts, and instead may be liable for excess costs incurred by the government in procuring undelivered items and services from another source. We cannot predict if the government will terminate or choose not to extend our Federal government contracts. The government has never terminated any of our contracts; however, it may do so at any time.

Because we have a highly concentrated customer base, the loss of any of our Federal government customers could have a significant effect on our revenues.

During the year ending December 31, 2009, we expect to derive approximately 90% of our consolidated revenue from contracts with Federal government agencies. If any of our current Federal government customers determines not to renew or terminate its contract, then our revenues may significantly decline.

The Federal government has rights and remedies under its contracts not typically found in commercial contracts that may reduce or eliminate our revenue under these contracts, as well as our ability to enter into other government contracts.

Federal government contracts contain provisions and are subject to laws and regulations that give the government rights and remedies not typically found in commercial contracts. The government may terminate its contracts for convenience or decline to exercise an option to renew. The government may also:

reduce or modify its contracts or subcontracts;

cancel multi-year contracts and related orders if funds for contract performance for any subsequent year become unavailable; and

suspend or bar us from doing business with the Federal government.

If the Federal government were to exercise any of these rights or remedies, then our revenues would decline.

Our failure to comply with complex procurement laws and regulations could result in the termination of our Federal government contracts or our failure to be awarded any new contracts, and changes in laws and regulations could impose added costs on our business.

We must comply with and are affected by laws and regulations relating to the formation, administration and performance of Federal government contracts, which affect how we do business with our customers and may impose added costs on our business. Among the most significant regulations are:

the Federal Acquisition Regulations and other agency regulations supplemental to the Federal Acquisition Regulations, which comprehensively regulate the formation, administration and performance of government contracts;

the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;

the Cost Accounting Standards and Cost Principles, which impose accounting requirements that govern our right to reimbursement under certain cost-based government contracts; and

laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Moreover, we are subject to industrial security regulations of the Department of Defense and other Federal agencies that are designed to safeguard against foreigners' access to classified information. If we were to come under foreign ownership, control or influence, then our Federal government customers could terminate or decide not to renew our contracts, and it could impair our ability to obtain new contracts.

Table of Contents

If we do not comply with the procurement laws and regulations discussed above, then we may be fined, we may not be reimbursed for costs incurred by us in servicing our contracts, our contracts may be terminated and we may be unable to obtain new contracts, any of which would cause our revenues to decline.

Our status as a GSA Federal Supply Schedule Contractor may be withdrawn, which would make us ineligible to obtain certain Federal government contracts and would result in a significant decrease in our revenues.

The GSA secures the buildings, products, services, technology and other workplace essentials which Federal agencies need to operate. GSA Federal Supply Schedule Contracts are contract vehicles under which Federal government agencies may purchase professional services or products. Federal government agencies may choose to award contracts only to GSA Federal Supply Schedule Contractors to reduce the number of qualified bidders and to expedite the bidding process. Paragon Systems has been approved by the GSA as a GSA Federal Supply Schedule Contractor and, therefore, is able to bid on Federal government contracts awarded using the GSA Federal Supply Schedule. Currently, eight of our contracts with annualized revenues of approximately \$75 million have been procured under the GSA Federal Supply Schedule. During the year ended December 31, 2008, the revenues on our contracts procured under the GSA Federal Supply Schedule totaled approximately 54% of our consolidated revenues for such period.

Our status as a GSA Federal Supply Schedule Contractor may be withdrawn if we do not comply with the complex procurement laws and regulations applicable to us. We continually review and monitor our compliance with these laws and regulations as well as modifications to the GSA Federal Supply Schedule affecting our business. We believe that we are currently in material compliance with these laws, regulations and modifications; however, if we are not in compliance and our status as a GSA Federal Supply Schedule Contractor is withdrawn, then we may not be able to obtain new contracts with Federal government agencies or renew our existing contracts which have been procured under the GSA Federal Supply Schedule. If we are unable to obtain new Federal government contracts or renew our existing contracts, then our revenues will decline significantly.

All of our contracts with the Federal government are subject to audits and cost adjustments by the Federal government that could result in decreased revenues and the imposition on us of civil or criminal penalties or administrative remedies.

We generate a significant portion of our revenue from Federal government contracts, each of which is subject to audit by the Federal government. In these audits, the Federal government audits and reviews our performance, pricing practices, cost structure and compliance with applicable laws, regulations and standards. Like most government contractors, our direct and indirect contract costs are audited and reviewed on a continual basis. Many of the audits for costs incurred or work performed in recent years remain ongoing or have not yet commenced. In addition, non-audit reviews by the government may still be conducted on all our government contracts. An audit of our work, including an audit of work performed by companies we may acquire, could result in a substantial adjustment to our revenue because any costs found to be improperly allocated to a specific contract will not be reimbursed and revenue we have already recognized may need to be refunded. If a government review or investigation uncovers improper or illegal activities, then we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of claims and profits, suspension of payments, treble damages, statutory penalties, fines and suspension or barment from doing business with Federal government agencies, any of which would cause a significant decline in our revenue.

Our participation in the competitive bidding process, pursuant to which we obtain most of our Federal government contracts, presents a number of risks.

During the year ended December 31, 2008, of our revenue derived from federal contracts, substantially all was awarded through a competitive bidding process. Most of the business that we expect to seek from the Federal government in the foreseeable future likely will be awarded through competitive bidding. Competitive bidding presents a number of risks, including:

the need to bid on programs in advance of finalizing the services to be provided, which may result in unforeseen difficulties and cost overruns;

Table of Contents

the substantial cost and managerial time and effort that we spend to prepare bids and proposals for contracts that may not be awarded to us;

the need to accurately estimate the resources and cost structure that will be required to service any contract we are awarded; and

the expense and delay that may arise if our competitors protest or challenge contract awards made to us pursuant to competitive bidding, which could result in the resubmission of bids on modified specifications or in termination, reduction or modification of the awarded contract.

If we are unable to win particular contracts that are awarded through the competitive bidding process, we may not be able to operate in the market for services that are provided under those contracts for a number of years. If we are unable to consistently win new contract awards over any extended period, then we will not be able to grow our business, and our business, financial condition and results of operations will be materially and adversely affected.

Our cash flow may be reduced due to significant expenses we may incur in connection with attempting to obtain Federal government contracts.

A significant portion of Federal government contracts for contract guard services is awarded through a competitive bid process. As stated above, substantial costs may be incurred in connection with preparing bids. In the past we have not, and most likely in the future will not, be awarded all the contracts on which we bid. Furthermore, if and when we do obtain a contract, we are generally required to start providing services pursuant to such contract no later than 30-45 days after the contract is awarded. As a result, we may incur significant start-up expenses. The costs of bidding on contracts and the start-up costs associated with new contracts we may obtain may significantly reduce our cash flow and liquidity.

The long sales cycles of Federal government contracts make it difficult for us to predict our financial results and cause us to expend a significant amount of effort and funds in bidding on contracts that are not awarded to us.

The sales cycle of a Federal government contract is often lengthy due to the protracted bid and approval process. Typically, many months may elapse between the time the Federal government solicits a bid for a contract and the time the contract is awarded. The lengthy sales cycles of our contracts make forecasting the volume and timing of contracts we may obtain difficult. During this period, we will generally expend substantial funds and management resources but recognize no associated revenue.

We may not receive the full amount authorized under contracts into which we have entered; consequently, our backlog may not accurately estimate our revenue.

The maximum contract value specified under a government contract that we enter into is not necessarily indicative of revenue that we will realize under that contract. In fact, even if we enter into a Federal government contract, we will not be paid for our services unless the Federal government has appropriated or budgeted the funds for such contract. Congress often appropriates funds for a particular program on a yearly basis, even though the contract may call for performance that is expected to take a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriations and the procuring agency allocates funding to the contract. As described above, most of our existing contracts are subject to modification and termination at the Federal government's discretion. Moreover, there is no assurance that any contract included in our estimated contract value that generates revenue will be profitable. Nevertheless, we look at these contract values, including values based on the assumed exercise of options relating to these contracts, in estimating the amount of our backlog. Because we may not receive the full amount we expect under a contract, our backlog may not accurately estimate our revenue.

If we are unable to obtain and maintain security clearances for our employees, then we will not be able to satisfy existing contracts or obtain new contracts.

Many of our Federal government contracts require our employees to maintain various levels of security clearances, and we are required to maintain certain facility security clearances complying with Federal government requirements. Obtaining and maintaining security clearances for employees involve a lengthy process, and it is difficult to identify,

Table of Contents

recruit and retain employees who already hold security clearances. If our employees are unable to obtain or retain security clearances or if our employees who hold security clearances terminate employment with us, then the customer whose work requires cleared employees could terminate the contract or decide not to renew it upon its expiration. In addition, we expect that many of the contracts on which we will bid will require us to demonstrate our ability to obtain facility security clearances and perform work with employees who hold specified types of security clearances. To the extent we are not able to obtain facility security clearances or engage employees with the required security clearances for a particular contract, we may not be able to satisfy our existing contracts, bid on or win new contracts or effectively re-compete on expiring contracts or follow-on task orders. To the extent we are unable to do any of the foregoing, our existing contracts may be terminated, we will not be able to grow our business and our revenues may decline.

Item 2. Properties

Our corporate headquarters and principal executive offices are located in Alpharetta, Georgia, and our contract guard services operations are located at the offices of our wholly-owned subsidiaries, Paragon Systems and Cornwall, in Chantilly, Virginia and Miami, Florida, respectively. We lease space at each of the foregoing locations. We are obligated to pay rent on the (i) Alpharetta, Georgia facility of approximately \$4,800 per month through November 2009; (ii) Chantilly, Virginia facility of approximately \$9,742 per month, with 4% annual increases, through November 2011; and (iii) the Miami, Florida facility of approximately \$7,259 per month through April 2009.

We believe our leased facilities are adequate to meet our needs and that additional facilities are available to us to meet our expansion needs for the foreseeable future on commercially reasonable terms.

Item 3. Legal Proceedings

Except as set forth below, we believe that, based on currently known facts, there are no claims or litigation pending against us the disposition of which would materially affect our financial position or future operating results, although we cannot be certain as to the ultimate outcome of any such claim or litigation. In addition, exposure to litigation is inherent in our ongoing business and may harm our business in the future.

Litigation Regarding Our Initial Public Offering

As previously disclosed, on November 1, 2006, a purported class action complaint was filed in the State Court of Fulton County, State of Georgia, against Tri-S, its Chief Executive Officer, its former Chief Financial Officer and the lead underwriters in Tri-S's initial public offering, alleging, among other things, violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, in connection with Tri-S's initial public offering (*Unschuld v. Tri-S Security Corp., et al.*, the *Unschuld Litigation*). More specifically, the complaint alleges that the registration statement relating to the initial public offering was materially inaccurate and misleading because it failed to disclose certain problems with the operations and financial condition of Paragon Systems of which the complaint alleges we were aware. The complaint seeks class certification, unspecified compensatory damages or rescission, as appropriate, and costs and disbursements relating to the lawsuit, including reasonable attorneys' fees. On December 1, 2006, Tri-S removed the lawsuit to the United States District Court for the Northern District of Georgia. Plaintiff moved to remand the case back to the state court, which motion was granted on September 14, 2007, and the case is now pending in the State Court of Fulton County, State of Georgia. Tri-S and the other defendants each filed answers in response to the Complaint on August 13, 2008. On that same date, they also filed a joint motion to dismiss, or in the alternative, a motion for judgment on the pleadings (the *Motion to Dismiss*) and a motion for a stay of discovery (the *Motion for Stay*) pending a decision on the Motion to Dismiss. Plaintiff opposed the Motion for Stay on October 8, 2008 and the Motion to Dismiss on October 16, 2008. The Court stayed proceedings in the action until March 9, 2009 because of the parties' on-going settlement discussions. On March 9, 2009, the parties filed a Joint Stipulation of Settlement and Release (the *Settlement Agreement*). The Court granted preliminary approval to the Settlement Agreement on March 10, 2009 (the *Preliminary Approval Order*). The Preliminary Approval Order (i) certified on a provisional basis a class of purchasers of certain Tri-S units, common stock, and warrants and (ii) scheduled a fairness hearing for June 1, 2009. Notice of the proposed settlement will be sent to potential class members and the class administrator will administer the notice and payment process. Under the terms of the Settlement Agreement and the Preliminary Approval Order, a payment of \$1,000,000 was made (on behalf of all defendants) on March 20, 2009 (the *Cash Settlement Payment*) in return for, among other things, a release and dismissal with prejudice of all claims against us and the other defendants. Our insurance carrier funded the Cash Settlement Payment. The final approval of the Settlement Agreement is subject to the satisfaction of certain conditions, including, without limitation, the entry by the Court of a final order approving the Settlement Agreement. If such final approval is not obtained, then the Settlement Agreement will become null and void.

Table of Contents

On December 10, 2007, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Axis Reinsurance Company and Axis Insurance Company (collectively Axis) for declaratory and injunctive relief. Axis issued a Directors, Officers, and Corporate Liability Insurance Policy to Tri-S for the period from March 13, 2006 to March 13, 2007 (the Axis Policy). Tri-S provided notice of the Unschuld Litigation to Axis on November 8, 2006. On November 9, 2007, attorneys for Axis informed Tri-S that Axis disclaimed coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that coverage for the Unschuld Litigation is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems and that Axis is required to advance defense costs incurred in connection with the Unschuld Litigation and (ii) an order requiring Axis to advance such defense costs. On April 11, 2008, Tri-S moved to dismiss Axis Insurance Company from the action without prejudice. The Court granted the motion on April 15, 2008. Axis Reinsurance Company removed the case to the United States District Court for the Northern District of Georgia on April 16, 2008 and filed an answer in that court on April 23, 2008. The parties stipulated to a voluntary dismissal of the action without prejudice on June 11, 2008 and the case was dismissed on June 12, 2008.

On March 13, 2008, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Capitol Specialty Insurance Corporation (Capitol), McGriff, Seibels & Williams of Georgia, Inc. and McGriff, Seibels & Williams, Inc. (collectively, McGriff), seeking declaratory relief and damages. McGriff acted as Tri-S's broker in obtaining the Axis Policy. Capitol issued a Directors and Officers Liability Insurance Policy to Tri-S for the period from February 9, 2005 to March 13, 2006 (the Capitol Policy). Tri-S provided notice under the Capitol Policy of the Unschuld Litigation on December 13, 2007. Coverage under that policy was denied on January 25, 2008. In the event that the Unschuld Litigation is not covered under the Axis Policy, Tri-S is seeking (i) a declaration that the Capitol Policy requires Capitol to advance defense costs in connection with the Unschuld Litigation; (ii) an order requiring Capitol to advance such defense costs; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for any such loss. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy in connection with the Unschuld Litigation, Tri-S is seeking (a) damages, in an amount to be determined at trial, against McGriff for negligence, breach of contract, negligence per se, negligent procurement, negligent misrepresentation, professional negligence, and breach of fiduciary duty; (b) a declaration that McGriff is required to cover any loss as defined in the Axis Policy that Tri-S incurs in connection with the Unschuld Litigation up to the limit of liability of the Axis Policy; and (c) an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. On April 11, 2008, Tri-S voluntarily dismissed the action without prejudice.

On May 13, 2008, Tri-S filed a complaint in the Superior Court of Fulton County, State of Georgia against Axis Reinsurance Company, Capitol, and McGriff combining Tri-S's claims related to coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that the Axis Policy provides coverage for loss incurred in connection with the Unschuld Litigation and that coverage is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems or by any other provision of the policy; (ii) an order requiring Axis to advance defense costs incurred in connection with the Unschuld Litigation; and (iii) an order requiring Axis to cover loss for claims related to the Unschuld Litigation. In the alternative, and to the extent the Unschuld Litigation is not covered by the Axis Policy, Tri-S seeks (i) a declaration that the Capitol Policy requires Capitol to pay defense expenses in connection with the Unschuld Litigation; (ii) an order requiring Capitol to pay such defense expenses; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for such loss. Tri-S also seeks damages against McGriff for negligence, breach of contract, and breach of fiduciary duty in an amount to be determined. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy, Tri-S further seeks a declaration that McGriff is required to cover loss incurred in connection with the Unschuld Litigation and an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. Axis answered the complaint and asserted affirmative defenses on June 11, 2008. Capitol answered the complaint and asserted affirmative defenses on July 17, 2008. The parties agreed to extend McGriff's time to answer through and including April 24, 2009.

Dispute with Miami-Dade General Services Administration

As previously disclosed, a search warrant was issued on January 17, 2008, by the Circuit Court of the eleventh judicial circuit in and for Miami-Dade County, Florida, to search the premises of Forestville Security, a subsidiary of Cornwall based in Miami, Florida, for any and all records or documents pertaining to the contract between Forestville

Table of Contents

Security and Miami-Dade General Services Administration for the period of April 1, 2005 to August 1, 2007. The search warrant states that Miami-Dade General Services Administration alleges that it has uncovered instances of fraudulent billing committed by Forestville Security in connection with the Miami-Dade General Services Administration contract. Forestville Security is fully cooperating with the authorities regarding the investigation.

We made a settlement offer of \$555,000 to Miami Dade County, which is fully reserved as of December 31, 2008, and believe we have reached an agreement in principle to settle the matter. This settlement offer is subject to the approval of the Board of County Commissioners. On April 7, 2009, the settlement was approved by the Miami-Dade County Commission.

Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of shareholders was held on December 19, 2008, in Alpharetta, Georgia (the Meeting). At the Meeting, our shareholders voted on proposals to: (i) elect two Class III directors each for a three-year term of office; (ii) ratify the appointment of Habib, Arogeti & Wynne LLP as our independent registered public accountants for the year ended December 31, 2008; and (iii) to approve an amendment to our 2004 Stock Incentive Plan, as amended and restated (the Incentive Plan), to (a) increase the number of shares authorized thereunder from 1,500,000 to 2,000,000, less the aggregate number of shares already issued thereunder and (b) provide that unvested, performance-based awards of restricted stock and stock bonuses be terminated and forfeited upon retirement. Each of the foregoing proposals was approved by our shareholders at the Meeting.

With respect to the proposal to elect two Class III directors, there (i) were 3,878,046 votes cast for the election of Mr. Farrell as a Class III director and 47,544 votes cast to withhold authority with respect to the election of Mr. Farrell as a Class III director; and (ii) there were 3,878,546 votes cast for the election of Lee K. Toole as a Class III director and 47,044 votes cast to withhold authority with respect to the election of Mr. Toole as a Class III director. There were no broker non-votes with respect to the election of Messrs. Farrell or Toole. After the Meeting, James M. Logsdon and James A. Verbrugge, who serve as Class I and Class II directors, respectively, continued their respective terms of office as directors.

With respect to the proposal to ratify the appointment of Habib, Arogeti & Wynne LLP as our independent registered public accountant for the year ended December 31, 2008, there were 3,904,317 votes cast in favor, 18,773 votes cast against, 2,500 votes cast to abstain and no broker non-votes.

With respect to the proposal to approve the amendment to the Incentive Plan, there were 1,454,435 votes cast in favor, 55,041 votes cast against, 5,500 votes cast to abstain and 2,410,614 broker non-votes.

The proposals presented at the Meeting were set forth and described in our Notice of Annual Meeting of Shareholders and Proxy Statement dated November 24, 2008.

Item 4.5 Executive Officers of the Registrant

Pursuant to General Instruction G (3) of Form 10-K under the Securities Exchange Act of 1934, as amended (the Exchange Act), the information regarding our executive officers required by Item 401 of Regulation S-K is hereby included in Part I of this Annual Report.

The following table sets forth the name of each of our executive officers, the office held by such officer and the age, as of March 31, 2009, of such officer:

Name	Age	Position
Ronald G. Farrell	65	Chairman of the Board, President and Chief Executive Officer
Nicolas Chater	55	Chief Financial Officer

Table of Contents

Certain additional information concerning the individuals named above is set forth below:

Mr. Farrell serves as our Chief Executive Officer and President and as a director of the Company. He served as our sole director and officer from our formation in October 2001 to our initial public offering in February 2005. From December 1998 to December 2001, Mr. Farrell served as Chairman of the Board and Chief Executive Officer of Golf Entertainment, Inc. At various times from 1986 through 1998, Mr. Farrell founded and served as Chairman of the Board and Chief Executive Officer of Computer Integration Corporation, Sports Leisure, Inc., Automotive Industries, Inc. and Builders Design, Inc.

Mr. Chater has served as our Chief Financial Officer since November 2007. From July 2004 through October 2007, Mr. Chater served as the Executive Vice President and Deputy Chief Financial Officer of HomeBanc Corp. and the Chief Financial Officer of HBMC. From 1996 until December 2003, Mr. Chater served as the Chief Financial Officer of various subsidiaries of Cap Gemini Ernst & Young.

There are no family relationships among any of our executive officers or directors. Except as disclosed in the section of this Annual Report titled Executive Compensation, no arrangement or understanding exists between any executive officer and any other person pursuant to which any executive officer was selected to serve as an executive officer. Our executive officers of the Company are elected or appointed by our board of directors and hold office until their successors are elected and qualified, or until their death, resignation or removal, subject to the terms of applicable employment agreements.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**
Market for Common Equity

Our common stock and the warrants we issued in our initial public offering are currently traded on the NASDAQ Capital Market under the symbols TRIS and TRISW, respectively. Our common stock and warrants first became publicly traded as separate quotations on the NASDAQ Capital Market on April 11, 2005. From February 9, 2005, the date of our initial public offering, until April 10, 2005, only the units sold in our initial public offering were publicly traded.

The following table sets forth the quarterly high and low sales prices for our common stock for the periods indicated below, as reported by the NASDAQ Capital Market. The stock prices set forth below do not include adjustments for retail mark-ups, markdowns or commissions, and represent inter-dealer prices and do not necessarily represent actual transactions.

Year Ended December 31, 2008	High	Low
Fourth Quarter of 2008	\$ 1.23	\$ 0.22
Third Quarter of 2008	\$ 2.14	\$ 0.83
Second Quarter of 2008	\$ 2.75	\$ 1.75
First Quarter of 2008	\$ 3.00	\$ 1.07
Year Ended December 31, 2007	High	Low
Fourth Quarter of 2007	\$ 2.31	\$ 1.32
Third Quarter of 2007	\$ 2.78	\$ 1.78
Second Quarter of 2007	\$ 4.05	\$ 2.28
First Quarter of 2007	\$ 2.85	\$ 1.90

As of March 31, 2009, there were approximately 13 holders of record of our common stock.

We have never declared or paid cash dividends on our common stock. We currently intend to retain any earnings for use in our operations and do not anticipate paying cash dividends on our common stock in the foreseeable future. In addition, the Amended and Restated Credit Agreement prohibits the payment of cash dividends on our common stock without our Lenders' prior written consent.

Unregistered Sales of Equity Securities and Use of Proceeds

On December 16, 2008, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$25,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 2,604 shares of our common stock at an exercise price of \$0.75 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$25,000, which matured in September 2008, previously issued by us to such investor.

On January 8, 2009, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$37,500, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 3,906 shares of common stock at an exercise price of \$0.95 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$37,500, which matured in October 2008, previously issued by us to such investor.

On February 3, 2009, we issued to an accredited investor: (i) a promissory note with a principal amount of \$50,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase

Table of Contents

5,208 shares of our common stock at an exercise price of \$0.75 per share. The investor agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$50,000, which matured in October 2008, previously issued by us to such investor.

The promissory notes and warrants issued by us as discussed above were issued without registration under the Securities Act, upon the exemption from registration set forth in Section 4(2) of the Securities Act and Regulation D promulgated thereunder (Regulation D). We based such reliance upon representations made by each investor regarding the investor's investment interest, sophistication and status as an accredited investor, as defined in Rule 501 of Regulation D, among other things.

On January 9, 2009, we issued to an agent who is a registered representative a warrant to purchase 65,000 shares of our common stock, exercisable for 8.5 years at \$2.33 per share. The warrant was issued to the agent as compensation for the agent's assistance to us in effecting our offer to exchange our outstanding 10% convertible promissory notes due 2008 for our 14% convertible promissory notes due 2010 and warrants to purchase shares of our common stock, pursuant to the terms and conditions set forth in our tender offer statement on Schedule TO, initially filed with the SEC on August 20, 2008, as amended (the Exchange Offer). The warrant issued to the agent was issued without registration under the Securities Act, upon the exemption from registration set forth in Section 4(2) of the Securities Act and Regulation D. We based such reliance upon representations made by the agent regarding the agent's investment interest, sophistication and status as an accredited investor, as defined in Rule 501 of Regulation D, among other things.

Issuer Purchases of Equity Securities

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
November 1, 2008 through November 30, 2008	10% convertible promissory notes with aggregate principal amount of \$6,590,000	(1)	10% convertible promissory notes with aggregate principal amount of \$6,590,000	0
December 1, 2008 through December 31, 2008	10% convertible promissory notes with an aggregate principal amount of \$50,000	(2)	0	0

- (1) Pursuant to the Exchange Offer, we exchanged our 10% convertible promissory notes due 2008 with an aggregate principal amount of \$6,590,000 for our 14% convertible promissory notes due 2010 with an equal aggregate principal amount and five-year warrants to purchase 686,490 shares of our common stock at an exercise price of \$0.66 per share. The Exchange Offer was announced on August 20, 2008, and terminated on November 13, 2008.
- (2) On December 16, 2008, we issued to each of two accredited investors: (i) a convertible promissory note with a principal amount of \$25,000, which accrues interest on the principal amount at a rate of 14% per annum and matures in November 2010; and (ii) a five-year warrant to purchase 2,604 shares of our common stock at an exercise price of \$0.75 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$25,000, which matured in September 2008, previously issued by us to such investor.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The results of operations set forth below for the years ended December 31, 2008, 2007 and 2006 are based on historical results for the Company.

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

In accordance with requirements of purchase accounting, the assets and liabilities of Paragon Systems and Cornwall were adjusted to their estimated fair values and the resulting goodwill computed for their acquisitions. The application of purchase accounting generally results in higher depreciation and amortization expense in periods subsequent to the acquisitions.

Overview

Through our two direct, wholly-owned subsidiaries, Paragon Systems and Cornwall, we provide equipment and security services to various government agencies and the private sector. Our services include uniformed guards, personnel protection, access control, crowd control and the prevention of sabotage, terrorist and criminal activities. In connection with providing these services, we assume responsibility for a variety of functions, including recruiting, hiring, training, arming and supervising guards deployed to the customers we serve as well as paying all guards and providing them with uniforms, fringe benefits and workers' compensation insurance.

During 2006, Paragon Systems formed SEP with Southeastern Protective Services, Inc. to provide security services pursuant to certain federal government contracts. The services provided by SEP are substantially the same as those provided by Paragon Systems. Paragon Systems owns 49% of SEP and manages the operations. Accordingly, the operations of SEP are included in the Tri-S's consolidated financial statements.

During 2007, Paragon Systems formed ODPS with On Duty Patrol Services, Inc. to provide security services pursuant to certain federal government contracts. The services provided by ODPS are substantially the same as those provided by Paragon Systems. Paragon Systems owns 49% of ODPS. ODPS has signed no contracts since its inception.

Our government customers include local, state and Federal government agencies. Our private sector customers include commercial customers, such as universities, public school systems, corporate complexes and hospitals, and residential customers, such as condominiums, high-end apartments and high-security homes.

We strive to provide cost-effective solutions to ensure the safety and security of the assets and personnel of our customers and to continually improve the protection we provide for their personnel, programs, resources and facilities. Our goal is to provide demonstrably superior contract guard services with the highest degree of integrity and responsiveness.

Table of Contents

In addition to our core business of providing equipment and security services, we owned a non-core business interest of providing logistics services. Through Paragon Systems, we owned a 10% equity interest in Army Fleet Support, which provides logistics support for U.S. Army aviation training at Fort Rucker, Alabama. We sold our 10% interest in Army Fleet Support for \$10.8 million in May 2006.

We were incorporated in Georgia in October 2001 under the name Diversified Security Corporation and changed our name to Tri-S Security Corporation in August 2004. We were formed for the purpose of acquiring and consolidating electronic and physical security companies in order to take advantage of the operating efficiencies created by a larger company. Our acquisition strategy involves the acquisition and integration of complementary businesses in order to increase our scale within certain geographic areas, capture market shares in the markets in which we operate and improve our profitability. We intend to pursue acquisition opportunities in the contract guard services and system integration services segments of the security industry. We frequently evaluate acquisition opportunities and, at any given time, may be in various stages of due diligence or preliminary discussions with respect to a number of potential acquisitions. From time to time, we may enter into non-binding letters of intent, but we are not currently subject to any definitive agreement with respect to any acquisition material to our operations or otherwise so far advanced in any discussions as to make an acquisition material to our operations reasonably certain.

We made our first acquisition on February 27, 2004, when we acquired all of the outstanding capital stock of Paragon Systems, a contract guard services and logistics provider for a purchase price of \$16,000,000. We made our second acquisition on October 18, 2005, when we acquired all of the outstanding capital stock of Cornwall, a provider of security and investigative services, including armed and unarmed uniform guards, video and alarm monitoring, alarm installation, and GPS monitoring, to government and private sector customers in the Miami, Florida area, for a total purchase price of \$13,500,000. In the first quarter of 2006, we disposed of substantially all of the assets of International Monitoring, Inc., a wholly-owned subsidiary of Cornwall, which provides residential security system monitoring.

Renewing and extending existing contracts and obtaining new contracts are crucial to our ability to generate revenue and manage cash flow. Our Federal government contracts, which generate a significant portion of our revenue, may be terminated at any time by the Federal government, or the Federal government may determine not to renew or extend any of such contracts upon their scheduled expiration. The Cornwall Acquisition has allowed us to diversify our customer base to include commercial customers. We must continue to sell commercial services to commercial customers in order to maintain our revenue system and to grow our business.

Critical Accounting Policies and Estimates

The following discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of these financial statements requires us to make judgments regarding estimates that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our judgments on historical experience and on various assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe our judgments and related estimates regarding the following accounting policies are critical in the preparation of our consolidated financial statements.

Revenue Recognition. Revenue is recorded monthly as guard services are provided to our customers under contracts. We bill guard services in arrears at hourly or monthly rates based on the number of hours worked under some contracts and as fixed monthly amounts under other contracts. Hourly and monthly rates are based on contractual terms.

The terms of our contracts are complex and may be subject to differing interpretations. We make estimates and judgments about terms of the contracts in providing services and in billing and recording revenue. At times, our Federal contracts require interpretations. Typically, differences in interpretation are resolved on a mutual basis in discussions with the government agency involved. The resolution of differences may result in a determination that amounts previously billed are not in accordance with contract terms and adjustments of amounts initially recorded as revenue may be material.

Contracts with Federal government agencies may be subject to cessation of funding. Cessation of funding may result in amounts billed and recorded as revenue as being uncollectible. We work with the appropriate government agency to resolve funding issues. When funding issues become known, we make estimates and judgments about the extent of

Table of Contents

potential losses and adjust revenues accordingly. Amounts estimated could differ from amounts ultimately collected and these amounts could be material. During the years ended December 31, 2006, 2007 and 2008, none of our contracts have been subject to cessation of funding.

Cost of Revenues. Cost of revenues is primarily comprised of labor, related payroll taxes, employee benefits, workers compensation, liability insurance, and the pro rata portion of the costs of customer contracts required.

We make estimates and judgments of amounts recorded for accruals of labor related costs. Expenses most subject to estimation and judgment are accrued vacation and workers compensation costs. The terms of vacation policies may be complex and subject to interpretation. Workers compensation insurance is subject to retroactive audit. Actual amounts could differ from the amounts initially recorded.

Impairment of Long-lived Assets, Goodwill and Intangible Assets. We evaluate impairment of long-lived assets, including property and equipment and intangible assets with finite lives, whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, then an impairment loss is recognized. Measurement of an impairment loss for long-lived assets is based on discounted cash flows and the fair value of an asset.

During 2008, certain of Cornwall's contracts with Miami-Dade County GSA, which represents approximately 37% of Cornwall's revenue during 2008, were not renewed. As a result of the non-renewal of these contracts, we determined that approximately \$6.3 million of goodwill at Cornwall was impaired and recorded goodwill impairment during the year ended December 31, 2008.

Investment in Army Fleet Support. We accounted for our 10% equity in Army Fleet Support, a joint venture which provides logistics support for U.S. Army aviation training at Fort Rucker, Alabama, using the equity method of accounting. Accordingly, our investment in Army Fleet Support is increased by our share of Army Fleet Support's earnings and reduced by the amortization of our investment in Army Fleet Support and the cash we receive from Army Fleet Support with respect to our investment. During the quarter ended June 30, 2006, we sold our equity interest in Army Fleet Support.

SFAS No. 123(R). On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123(R) (revised 2004), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation (SFAS No. 123(R)). SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. The approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in FASB Statement 123. However, 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 and no longer allows pro forma disclosure as an alternative to financial statement recognition.

Effective January 1, 2006, we adopted SFAS No. 123(R) using the modified prospective method and, therefore, reflect compensation expense in accordance with the SFAS No. 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates. See Note 3 to our consolidated financial statements included elsewhere in this Annual Report for information on the impact of our adoption of SFAS No. 123R.

Table of Contents**Results of Operations for the Years Ended December 31, 2008, 2007 and 2006**

The following table sets forth absolute dollar and percentage changes in our selected financial data from period to period for the periods described below. The table below combines results of Paragon Systems with Tri-S for periods prior to the Paragon Acquisition (dollars in thousands):

	Change from Year Ended December 31, 2007 to Year Ended December 31, 2008		Change from Year Ended December 31, 2006 to Year Ended December 31, 2007		Change from Year Ended December 31, 2005 to Year Ended December 31, 2006	
	\$	%	\$	%	\$	%
	Revenues	\$ 52,389	58.9%	\$ 13,218	17.5%	\$ 33,740
Operating expenses:						
Direct labor	(34,443)	(60.8)	(9,328)	(19.7)	(22,947)	(94.0)
Indirect labor and other contract support costs	(13,961)	(55.5)	(5,917)	(30.7)	(5,202)	(37.0)
Selling, general and administrative	(2,224)	(19.6)	312	2.7	(5,549)	(90.5)
Amortization of customer contracts and intangible assets	(5,954)	(434.0)	22	0.9	(1,610)	(168.4)
Operating loss	(4,193)	(61.4)	(1,693)	(33.0)	(1,568)	(44.0)
Income from investment in Army Fleet Support			(384)	(100.0)	(1,393)	(78.4)
Interest expense	(2,512)	(102.4)	680	22.0	(1,763)	(127.5)
Interest on Series C Redeemable Preferred Stock	211	100.0	89	29.7		
Other income(expense)	(2,500)	(98.1)	(106)	(3.9)	2,921	1,098.1
Loss before income taxes	(8,994)	(129.6)	(1,414)	(25.6)	(1,835)	(49.7)

Revenue. The increase in revenue from 2007 to 2008 is primarily the result of five new Federal government contracts obtained by Paragon Systems, net of four contract expirations. Revenue increases at Paragon Systems were offset slightly by lower revenue at Cornwall due to lost contracts.

The increase in revenue from 2006 to 2007 is primarily the result of six new Federal government contracts obtained by Paragon Systems, net of one contract expiration, and growth in revenue at SEP due to including a full year's impact of revenue in 2007 versus a partial year in 2006. Revenue increases at Paragon Systems and SEP were offset slightly by lower revenue at Cornwall due to lost contracts.

The following table sets forth the number of our Federal government contracts for Paragon Systems during the periods and in the revenue ranges indicated in the table:

Annual Revenues	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Less Than \$1.0 Million per Contract	1	4	8
\$1.0 to \$3.0 Million per Contract	9	7	4
Greater than \$3.0 Million per Contract	11	7	4

On December 31, 2008, 18 total contracts were active of which Paragon Systems served 16 and SEP served two.

The following table sets forth the years in which our contracts existing as of December 31, 2008 will expire:

Number of Contracts	Year Expiring
1	2009
8	2011
4	2012

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

4	2013
1	2018

Costs of Revenues. We categorize our cost of revenues into three areas: (i) direct labor; (ii) indirect labor and other contract support costs; and (iii) amortization of government contracts.

Direct Labor. Direct labor is the most significant expense in providing guard services on any contract. When bidding on contracts, we must anticipate labor rates during the contract term. Direct labor as a percentage of revenue was consistent from 2007 to 2008, approximating 64.5% of revenue in 2008 and 63.7% in 2007.

Table of Contents

Direct labor was approximately 62.5% of revenue in 2006. The increase in direct labor as a percentage of revenue from 2006 to 2007 is primarily due to the start up costs and pricing pressure on six new Federal government contracts obtained by Paragon.

Indirect Labor and Other Contract Support Costs. This category of expenses consists primarily of indirect labor (guard supervisors), our portion of payroll taxes, employee benefit costs and other expenses. Other expenses comprise a relatively small portion of costs in this category. As with direct labor, when bidding on contracts, we must anticipate the cost of providing supervisory oversight of the guards performing the actual guard services and the related payroll taxes and employee benefits that are provided to both guards and supervisors. Indirect labor and other contract support costs as a percentage of revenue improved slightly from 2007 to 2008, as these costs were approximately 27.7% of revenue in 2008 and 28.3% of revenue in 2007. This improvement is due primarily to lower insurance costs as a percent of revenue at both Paragon Systems and Cornwall.

Indirect labor and other contract support costs as a percentage of revenue in 2006 was 25.4%. The increase of these costs from 2006 to 2007 is again due primarily to start up costs on the six new Federal government contracts obtained by Paragon Systems in 2007. In addition, Cornwall costs increased as a result of higher workers compensation claims of \$0.9M incurred in 2007 over 2006.

Amortization of Government Contracts. Upon the consummation of each of the Paragon Acquisition and the Cornwall Acquisition, the existing contracts were valued in accordance with purchase accounting rules and the resulting asset values are being amortized over the remaining term of each contract proportionate to estimated future discounted cash flows based on an independent appraisal.

Total Cost of Revenue. Our total cost of revenue was 93.3% of revenue in 2008, 93.8% of revenue in 2007 and 90.1% of revenue in 2006.

Selling, General and Administrative Expenses. Selling, general and administrative expenses as a percentage of revenue was 9.6% in 2008, 12.8% in 2007 and 15.4% in 2006. Selling, general and administrative expenses consist primarily of payroll and related expenses for administrative personnel in our operations offices located in Chantilly, Virginia and Miami, Florida and in our corporate office located in Alpharetta, Georgia. It also includes occupancy costs at the office locations, consulting and professional fees, and certain miscellaneous office and corporation expenses. Selling, general and administrative expenses increased by approximately \$2.2 million from 2007 to 2008. The increase is due primarily to higher bank fees associated with higher revenue, one-time costs associated with settling the Miami-Dade billing dispute with a subsidiary of Cornwall, and higher non-cash costs associated with stock options, warrants and restricted stock issued in 2008.

Selling, general and administrative expenses decreased by approximately \$312,000 from 2006 to 2007. The decrease is due to lower costs at Paragon Systems and Cornwall as a result of lower headcount and related support costs, offset somewhat by higher professional fees related to the implementation of Sarbanes Oxley and higher stock option expense.

Goodwill impairment. During 2008, certain of Cornwall's contracts with Miami-Dade County GSA, which represents approximately 37% of Cornwall's revenue during 2008, were not renewed. As a result of the non-renewal of these contracts, we determined that approximately \$6.3 million of goodwill at Cornwall was impaired and recorded goodwill impairment during the year ended December 31, 2008.

Joint Venture. Until May 2006, we owned a 10% equity interest in Army Fleet Support. We recognized as income 10% of the Army Fleet Support's net earnings or net loss less the amortization of the difference between our cost and our share of the net equity of Army Fleet Support. In 2006 and 2005, we recognized income of \$659,000 and \$2,601,000 less amortization of \$275,000 and \$824,000 for net income of \$384,000 and \$1,777,000 with respect to our interest in Army Fleet Support, respectively. In May 2006, we recognized a gain on the sale of the Army Fleet Support of \$1,903,000. As a result of the sale in 2006, no revenue was recognized in 2007 or 2008.

Interest Expense. The interest expense for 2008 relates to the interest incurred on our Loan and Security Agreement, the 2007 Term Loan and the interest expense incurred on our 10% and 14% convertible promissory notes. Interest expense is higher in 2008 compared to 2007 due primarily to higher outstanding balances on our Loan and Security Agreement in 2008.

Table of Contents

The interest expense for 2007 relates to the interest incurred on our Loan and Security Agreement, the 2007 Term Loan, our mandatory redeemable preferred stock and the interest expense incurred on our 10% convertible promissory notes.

The interest expense for 2006 relates to the interest incurred on our Loan and Security Agreement and our outstanding Series C Redeemable Preferred Stock, and the interest expense incurred on our 10% convertible promissory notes. Interest expense was also incurred on two term loans under the Original Credit Agreement that were repaid in May 2006. Interest expense is lower in 2007 compared to 2006, primarily as a result of the payoff of the two term loans in May 2006, and payment of default interest in 2006 not also incurred in 2007.

Income Tax Expense. The income tax benefit for 2008, 2007 and 2006 was \$87,000, \$2.6 million and \$1.7 million, respectively, which was 0.7%, 38.0% and 30.6% of the loss before income taxes generated during 2008, 2007 and 2006, respectively.

Liquidity and Capital Resources

As of December 31, 2008, we had \$1.2 million of cash on hand. Cash used by operating activities was \$6.4 million for the year ended December 31, 2008. The cash used by operations was primarily due to the net loss of \$15.8 million, less non-cash items of depreciation and amortization expense of \$2.7 million and the goodwill impairment loss of \$6.3 million, the increase in unbilled revenues and trade accounts receivable of \$3.4 million, partially offset by the increase in accrued liabilities of \$3.3 million.

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2008, is approximately \$22.7 million. Additionally, from time to time during 2008, we have borrowed more than the maximum amount allowable under the availability formula under the Loan and Security Agreement and the Original Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, we were not in compliance with the Amended and Restated Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, we entered into the Forbearance Agreement with our Lenders. Pursuant to the Forbearance Agreement, our Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forbear from exercising all remedies available to our Lenders in connection with such existing defaults until the earlier of a potential equity or subordinated debt offering or January 1, 2009. On December 12, 2008, the Forbearance Agreement was amended to extend the end of the Forbearance period from January 1, 2009 to January 1, 2010.

We have historically incurred losses and has not yet generated sufficient levels of cash flows from operating activities to meet our scheduled debt service payments and other obligations. On November 13, 2008, we completed the Exchange Offer pursuant to which we exchanged approximately \$6.5 million, or 86%, of the aggregate principal amount of our outstanding 10% convertible promissory notes for our 14% convertible promissory notes and warrants.

The future success of the Company is dependent upon, among other things, our ability to: achieve and maintain satisfactory levels of profitable operations; obtain and maintain adequate levels of debt and/or equity financing; and provide sufficient cash flow from operations to meet current and future obligations. We anticipate the recently awarded contracts along with the initiatives instituted to maximize cash flows and raise additional equity will alleviate any short-term liquidity issues facing us and will contribute toward achieving profitability and positive cash flow.

Off-Balance Sheet Arrangements

We do not have any material off-balance sheet arrangements.

Income Taxes

We adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition

Table of Contents

issues. The adoption of FIN 48 resulted in the recognition of \$32,104 of penalties which was recorded as an adjustment to the January 1, 2007 retained earnings. No adjustments were made during 2008, to the balance of unrecognized tax benefits and no material change is expected in the next twelve months.

Recent Accounting Pronouncements

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations* (SFAS No. 141(R)), which will change the accounting for and reporting of business combination transactions. The most significant changes in the accounting for business combinations under SFAS No. 141(R) include: (i) valuation of any acquirer shares issued as purchase consideration will be measured at fair value as of the acquisition date; (ii) contingent purchase consideration, if any, will generally be measured and recorded at the acquisition date, at fair value, with any subsequent change in fair value reflected in earnings rather than through an adjustment to the purchase price allocation; (iii) acquired in-process research and development costs, which have historically been expensed immediately upon acquisition, will now be capitalized at their acquisition date fair values, measured for impairment over the remaining development period and, upon completion of a successful development project, amortized to expense over the asset's estimated useful life; (iv) acquisition related costs will be expensed as incurred rather than capitalized as part of the purchase price allocation; and (v) acquisition related restructuring cost accruals will be reflected within the acquisition accounting only if certain specific criteria are met as of the acquisition date; the prior accounting convention, which permitted an acquirer to record restructuring accruals within the purchase price allocation as long as certain, broad criteria had been met, generally around formulating, finalizing and communicating certain exit activities, will no longer be permitted. SFAS No. 141(R) will be effective for all business combinations consummated beginning January 1, 2009. Earlier adoption is not permitted. The impact of adopting SFAS No. 141R will be dependent on the business combinations that the Company may pursue after its effective date.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. For financial assets and liabilities, this statement was effective for fiscal periods beginning after November 15, 2007, and did not require any new fair value measurements. In February 2008, the FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157* (SFAS No. 157-2), was issued which delayed the effective date of SFAS No. 157 to fiscal years ending after November 15, 2008, for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

The Company adopted SFAS No. 157 as related to financial assets and liabilities in the first quarter of 2008. As a result, the Company was not required to recognize any new assets or liabilities at fair value.

The Company adopted SFAS No. 157-2 in the fourth quarter of 2008. The adoption did not have a material impact on our consolidated financial statements.

In October 2008, the FASB issued FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active*, providing guidance on calculating fair value in an inactive market (SFAS No. 157-3). SFAS No. 157-3 is effective upon issuance, including prior periods for which financial statements have not been issued. The adoption of SFAS No. 157-3 does not have an impact on our consolidated financial statements.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits many financial instruments and certain other items to be measured at fair value at the option of the Company. Most of the provisions in SFAS No. 159 are elective; however, the amendment to SFAS No. 115,

Accounting for Certain Investments in Debt and Equity Securities, applies to all entities with available-for-sale and trading securities. The fair value option established by SFAS No. 159 permits the choice to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings at each subsequent reporting date. The fair value option: (i) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (ii) is irrevocable (unless a new election date occurs); and (iii) is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective for financial statements issued for the first fiscal year beginning after November 15, 2007. Early adoption is permitted provided that the choice be made in the first 120 days of that fiscal year and SFAS No. 157 is also adopted. The Company is currently evaluating the impact, if any, that this new standard will have on the Company's results of operations, financial position or cash flows.

Table of Contents

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements* (SFAS No. 160), an amendment of Accounting Research Bulletin No. 51. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the non-controlling interest, changes in a parent's ownership interest, and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. Statement No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We will adopt SFAS No. 160 in the first quarter of fiscal 2009. We do not expect this statement will have a material impact on our future results of operations and financial condition.

In May 2008, FASB issued FSP Accounting Principles Board Opinion No. 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (APB 14-1). This FSP clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. This FSP requires issuers to account separately for the liability and equity components of certain convertible debt instruments in a manner that reflects the issuer's nonconvertible debt (unsecured debt) borrowing rate when interest cost is recognized. This FSP requires bifurcation of a component of the debt, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our consolidated statement of operations. This FSP requires retrospective application to the terms of instruments as they existed for all periods presented. The Company does not expect the adoption of APB 14-1 to have a material impact on the Company's financial statements.

Item 8. Financial Statements and Supplementary Data

The financial statements required to be filed with this Annual Report are filed under Item 15 hereof and are listed on the Index to Consolidated Financial Statements on page F-1 hereof.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

On November 1, 2008, Tauber & Balsler, P.C. (T&B) resigned as our independent accountant. T&B entered into an agreement with Habif, Arogeti & Wynne, LLP (HA&W), pursuant to which T&B combined its operations into HA&W and certain of the T&B professional staff and shareholders joined HA&W either as employees or partners of HA&W. The report of T&B regarding the company's financial statements for the fiscal years ended December 31, 2007 and 2006 did not contain any adverse opinion or disclaimer of opinion and was not qualified or modified as to uncertainty, audit scope or accounting principles. During the years ended December 31, 2007 and 2006 and during the period from the end of the most recently completed fiscal year through November 1, 2008, the date of resignation, there were no disagreements with T&B on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of T&B, would have caused it to make reference to such disagreements in its reports. During our two most recent fiscal years and through November 1, 2008, there were no reportable events as defined in Item 304(a)(1)(v) of Regulation S-K. Concurrent with the resignation of T&B, our Audit Committee appointed HA&W as the company's new independent accountant.

Item 9A(T). Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.*

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, as of December 31, 2008. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of December 31, 2008, due to material weakness that existed as of December 31, 2008, within our internal control over financial reporting as described below in Management's Report on Internal Control Over Financial Reporting.

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Notwithstanding the material weakness identified below, we performed additional detailed procedures and analysis and other post-closing procedures during the preparation of our consolidated financial statements included in this Annual Report, and our management has concluded that such consolidated financial statements present fairly our financial condition, results of operations, and cash flows for the fiscal years covered thereby in all material respects in accordance with GAAP. These reviews and control activities include performing detailed account reconciliations of all relevant account balances in order to confirm the accuracy of, and to correct any material inaccuracies in, those accounts as part of the preparation of such consolidated financial statements.

The required certifications of our Chief Executive Officer and our Chief Financial Officer are included as exhibits to this Annual Report. The disclosures set forth in this Item 9A contain information concerning the evaluation of our disclosure controls and procedures, internal control over financial reporting and changes to internal control referred to in those certifications. Those certifications should be read in conjunction with this Item 9A for a more complete understanding of the matters covered by the certifications.

(b) Management's Report on Internal Control Over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act. Our internal control over financial reporting is intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

In accordance with the internal control reporting requirements of the SEC, our management completed an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework summarizes each of the components of a company's internal control system, including the: (i) control environment; (ii) risk assessment; (iii) information and communication; and (iv) monitoring, as well as a company's control activities. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Table of Contents

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

In the course of our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2008, we identified a material weakness in our internal control over financial reporting in that we did not maintain effective controls over the completeness and accuracy of certain accrued liabilities and related expense accounts with respect to payroll. Specifically, effective controls which were designed and in place to ensure the complete and accurate recording of accrued liabilities and related expenses at each period end with respect to payroll were not followed.

Due to the material weakness described above, our management has determined our internal control over financial reporting as of December 31, 2008, was not effective.

This Annual Report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's report in this Annual Report.

Changes in internal control over financial reporting were made during the second quarter of 2009. These changes resulted mainly from remediation efforts, including the actions described below, and were designed mainly to address the material weakness identified by management.

(c) Changes in Internal Control Over Financial Reporting.

We regularly review our system of internal control over financial reporting and make changes to our processes and systems to improve controls and increase efficiency, while ensuring that we maintain an effective internal control environment. Changes may include such activities as implementing new, more efficient systems, consolidating activities, and migrating processes.

There were no changes in our internal control over financial reporting that occurred during the fourth quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In the second quarter of 2009, the Company's management identified discrepancies involving payroll transactions that began during 2008. These discrepancies, which amounted to approximately \$1.7 million during 2008, first identified by the Company's management, were the result of the lack of adherence to established reconciliation procedures. After reviewing these transactions and the ways in which they were reported and accounted for, management determined that such discrepancies will be prevented in the future by adhering to established reconciliation and review procedures. In addition, the Company intends on hiring additional qualified accounting staff in the near term.

Item 9B. Other Information

None.

Table of Contents

PART III

ITEM 10. Directors, Executive Officers of the Registrant and Corporate Governance

The information required by this Item is incorporated herein by reference to the sections of our proxy statement for our 2009 Annual Meeting of Shareholders (the Proxy Statement) titled Proposal I: Election of Directors, Section 16(a) Beneficial Ownership Reporting Compliance and Code of Ethics.

ITEM 11. Executive Compensation

The information required by this Item is incorporated herein by reference to the section of our Proxy Statement titled Compensation of Directors and Executive Officers.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated herein by reference to the sections of our Proxy Statement titled Security Ownership of Management and Certain Beneficial Owners and Equity Compensation Plans.

ITEM 13. Certain Relationships and Related Transactions and Director Independence

The information required by this Item is incorporated herein by reference to the sections of our Proxy Statement titled Certain Relationships and Related Transactions and Proposal I: Election of Directors.

ITEM 14. Principal Accountant Fees and Services

The information required by this Item is incorporated herein by reference to the section of our Proxy Statement titled Proposal 2 Ratification of Appointment of Independent Registered Public Accountants.

ITEM 15. Index to Financial Statements

(a) The following documents are filed as part of this Annual Report:

(1) Index to Consolidated Financial Statements

	Page
Tri-S Security Corporation and Subsidiaries:	
<u>Reports of Independent Registered Public Accounting Firms</u>	F-1
Financial Statements	
<u>Balance Sheets</u>	F-3
<u>Statements of Operations</u>	F-4
<u>Statements of Shareholders' Equity (Deficit)</u>	F-5
<u>Statements of Cash Flows</u>	F-6
<u>Notes to Financial Statements</u>	F-7

(2) Financial Statement Schedules

(3) Exhibits. The exhibits required to be filed with this Annual Report are listed on the Exhibit Index filed herewith. In reviewing the agreements included as exhibits to this Annual Report, please remember they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about the Company or the other parties to the agreements. Some of the agreements contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other parties to the applicable agreement and:

Should not in all instances be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate;

Have been qualified by the disclosures that were made to the other party in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;

May apply standards of materiality in a way that is different from what may be viewed as material to you or other investors; and

Were made only as of the date of the applicable agreement or such other date or dates may be specified in the agreement and are subject to more recent developments.

Accordingly, the representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about the Company may be found elsewhere in this Annual Report and our other public filings, which are available without charge on our website at www.trissecurity.com.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

Tri-S Security Corporation

We have audited the accompanying consolidated balance sheet of Tri-S Security Corporation and subsidiaries (the Company) as of December 31, 2008, and the related consolidated statements of operations, shareholders' equity and cash flows for the year ended December 31, 2008. Our audit also included the financial statement schedule listed at Item 15. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tri-S Security Corporation and subsidiaries at December 31, 2008, and the results of their operations and cash flows for the year ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respect the information set forth therein.

/s/ Habib, Arogeti & Wynne, LLP

Atlanta, Georgia
April 13, 2009

F-1

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

Tri-S Security Corporation

We have audited the accompanying consolidated balance sheet of Tri-S Security Corporation and subsidiaries (the Company) as of December 31, 2007, and the related consolidated statements of operations, shareholders' equity and cash flows for the years ended December 31, 2007 and 2006. Our audits also included the financial statement schedule listed as Item 15. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tri-S Security Corporation and subsidiaries at December 31, 2007, and the results of their operations and cash flows for the years ended December 31, 2007 and 2006 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respect the information set forth therein.

As discussed in Note 3 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share Based Payment*, effective January 1, 2006.

/s/ Tauber & Balsler, P.C.

Atlanta, Georgia

March 31, 2008

Table of Contents**Tri-S Security Corporation and Subsidiaries****Consolidated Balance Sheets****(In thousands, except per share data)**

	December 31,	
	2008	2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,246	\$ 465
Restricted cash	75	348
Unbilled revenues and trade accounts receivable, net of allowance for doubtful accounts of \$1,305 and \$701, respectively	16,610	13,993
Prepaid expenses and other assets	903	353
Total current assets	18,834	15,159
Property and equipment, less accumulated depreciation	611	476
Goodwill	9,825	16,078
Intangibles, net		
Customer contracts	1,028	2,647
Deferred loan cost	797	515
Other	665	769
Total assets	\$ 31,760	\$ 35,644
Liabilities and Stockholders Equity (Deficit)		
Current liabilities:		
Trade accounts payable	\$ 1,885	\$ 1,983
Accrued expenses	2,058	550
Accrued salary and benefits	5,676	3,940
Accrued interest	534	353
Income taxes payable	67	586
Factoring facility	19,641	11,625
10% convertible notes	1,025	7,473
Total current liabilities	30,886	26,510
Other liabilities:		
14% convertible notes	6,470	
Term loan	2,500	2,500
Accrued interest long term	277	353
Series D preferred stock subject to mandatory redemption	1,500	1,500
Total liabilities	41,633	30,863
Stockholders equity (deficit) :		
Common stock, \$0.001 par value, 25,000,000 shares authorized, 4,248,704 issued and 4,203,280 shares outstanding at December 31, 2008 and 2007	4	4
Treasury stock 45,424 shares at cost	(105)	(105)
Additional paid-in capital	17,562	16,368
Deficit	(27,334)	(11,486)

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Total stockholders' equity (deficit)	(9,873)	4,781
Total liabilities and stockholders' equity (deficit)	\$ 31,760	\$ 35,644

See accompanying notes to consolidated financial statements.

F-3

Table of Contents**Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Operations****(In thousands, except per share data)**

	Year Ended December 31,		
	2008	2007	2006
Revenues	\$ 141,332	\$ 88,943	\$ 75,725
Cost of revenues:			
Direct labor	91,124	56,681	47,353
Indirect labor and other contract support costs	39,134	25,173	19,256
Amortization of customer contracts	1,619	1,617	1,638
	131,877	83,471	68,247
Gross profit	9,455	5,472	7,478
Selling, general and administrative	13,594	11,370	11,682
Goodwill impairment	6,253		
Amortization of intangible assets	626	927	928
Operating loss	(11,018)	(6,825)	(5,132)
Income from joint venture, net			384
Interest and other income (expense):			
Interest expense, net	(4,966)	(2,454)	(3,134)
Interest on preferred stock subject to mandatory redemption		(211)	(300)
Gain on sale of non-core assets			2,381
Other income (expense)	49	2,549	274
	(4,917)	(116)	(779)
Loss before income taxes	(15,935)	(6,941)	(5,527)
Income tax benefit	87	2,638	1,694
Net loss	\$ (15,848)	\$ (4,303)	\$ (3,833)
Basic and diluted loss per common share	\$ (3.77)	\$ (1.02)	\$ (1.11)
Basic and diluted weighted average number of common shares	4,203	4,203	3,448

See accompanying notes to consolidated financial statements.

Table of Contents**Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Shareholders Equity (Deficit)****(In thousands)**

	Common Stock		Treasury Stock		Additional	Retained	Total
	Shares	Cost	Shares	Cost	Paid-in	Deficit	
					Capital		
Balance at December 31, 2005	3,339	\$ 3		\$	13,749	\$ (3,318)	\$ 10,434
Shares issued for services	40				180		180
Shares issued for conversion of notes payable	73				326		326
Note receivable repaid through issuance of treasury stock			45	(105)			(105)
Options exercised	97				12		12
IPO expenses					(108)		(108)
Beneficial conversion of convertible notes					(425)		(425)
Stock compensation					375		375
FIN 48 Adjustment						(32)	(32)
Net loss						(3,833)	(3,833)
Balance at December 31, 2006	3,549	3	45	(105)	14,109	(7,183)	6,824
Shares issued for Paragon settlement	700	1			1,597		1,598
Beneficial conversion					426		426
Stock compensation					236		236
Net loss						(4,303)	(4,303)
Balance at December 31, 2007	4,249	4	45	(105)	16,368	(11,486)	4,781
Stock compensation					831		831
Warrants issued to extend term loan					68		68
Warrants issued as part of tender offer					295		295
Net loss						(15,848)	(15,848)
Balance at December 31, 2008	4,249	\$ 4	45	\$ (105)	\$ 17,562	\$ (27,334)	\$ (9,873)

See accompanying notes to consolidated financial statements.

Table of Contents**Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Cash Flows****(In thousands)**

	Year Ended December 31,		
	2008	2007	2006
Cash flow from operating activities:			
Net loss	\$ (15,848)	\$ (4,303)	\$ (3,833)
Adjustments to reconcile net loss to net cash used by operating activities:			
Gain on Paragon settlement		(1,888)	
Gain on Cornwall settlement		(250)	
Gain on sale of non-core assets			(2,381)
Income from joint venture, net			(384)
Bad debt expense	777	488	59
Depreciation and amortization	2,725	2,920	2,909
Goodwill impairment	6,253		
Deferred income tax benefits		(1,974)	(3,095)
Common shares, options and warrants in exchange for services and interest	831	238	377
Non-cash interest expense	22	837	875
Changes in operating assets and liabilities, net of effects of acquisition:			
Unbilled revenues and trade accounts receivable	(3,394)	(1,168)	(2,345)
Prepaid expenses and other assets	(550)	191	326
Trade accounts payable	(98)	878	(95)
Accrued liabilities	3,349	319	(1,486)
Income taxes payable	(519)	(683)	1,426
Net cash used by operating activities	(6,452)	(4,395)	(7,647)
Cash flow from investing activities:			
Acquisition of subsidiary, net of cash acquired			(3)
Proceeds from sale of investment in joint venture			10,810
Distributions from investment in joint venture			175
Proceeds from sale of assets			1,301
Change in restricted cash	273	(243)	92
Purchase of property and equipment	(615)	(254)	(203)
Net cash provided (used) by investing activities	(342)	(497)	12,172
Cash flow from financing activities:			
Proceeds from exercise of stock options			9
Payment made for Paragon settlement		(1,250)	
Proceeds from factoring facility, net	8,016	4,119	315
Proceeds of (repayments on) term loans		2,500	(5,092)
Deferred financing costs	(441)	(78)	(43)
Deferred initial public offering costs			(111)
Net cash provided (used) by financing activities	7,575	5,291	(4,922)
Net increase (decrease) in cash and cash equivalents	781	399	(397)
Cash and cash equivalents at beginning of period	465	66	463
Cash and cash equivalents at end of period	\$ 1,246	\$ 465	\$ 66

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Supplemental disclosures of cash flow information:

Interest paid	\$ 4,377	\$ 1,850	\$ 1,873
Income taxes paid	432	15	149
Tender of 10% convertible notes in exchange for issuance of 14% convertible notes	6,460		
Satisfaction of officer note through issuance of treasury stock			105
Payment of deferred financing costs through issuance of warrants	363		

See accompanying notes to consolidated financial statements.

F-6

Table of Contents

Tri-S Security Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(dollars in thousands, except per share data)

1. Organization and Nature of Business

Tri-S Security Corporation, a Georgia corporation (Tri-S , the Company or We), was incorporated in October 2001 under the name Diversified Security Corporation. We changed our name to Tri-S Security Corporation on August 16, 2004. We provide contract guard services to: (i) various Federal government agencies through our subsidiary, Paragon Systems, Inc., an Alabama corporation with its principal office located in Washington, DC (Paragon Systems), and a joint venture in which we are a 49% partner, Southeastern Paragon (SEP) (ii) commercial and state and local government customers through our subsidiary, The Cornwall Group (Cornwall), a Florida Corporation with its principal offices located in Miami, Florida.

Tri-S was formed for the purpose of acquiring and consolidating electronic and physical security companies in order to take advantage of the operating efficiencies created by a large company. Tri-S has acquired and continues to pursue acquisition opportunities in the contract guard services and system integration services segments of the security industry.

We provide cost-effective solutions to ensure the safety and security of the assets and personnel of our customers and to continually improve the protection we provide for their personnel, programs, resources and facilities. Our goal is to provide demonstrably superior contract guard services with the highest degree of integrity and responsiveness. The Company has two reportable segments: Cornwall and Paragon/SEP.

2. Basis of Presentation and Principles of Consolidation

Summary of Significant Accounting Policies

On October 18, 2005, the Company acquired all of the outstanding capital stock of Cornwall for a total purchase price of \$13.5 million, payable in cash and a note. The acquisition was accounted for as a purchase and the results of Cornwall's operations are included in the Tri-S consolidated financial statements from the date of acquisition.

In January 2006, Paragon Systems entered into a Joint Venture Agreement with Southeastern Protective Services, Inc. (Southeastern Protective Services) to form SEP. Paragon Systems owns 49% and Southeastern Protective Services owns 51% of SEP. SEP was formed to bid on certain contracts, and Paragon Systems will manage the contracts awarded to SEP. We are accounting for the joint venture in accordance with FASB Interpretation No. 46 (R) Variable Interest Entities because we believe that SEP is a VIE in which we are the primary beneficiary. In 2007, Tri-S recorded revenue from SEP of \$5.7 million.

In September, 2007, Paragon Systems formed On Duty Patrol Services LLC (ODPS), a joint venture between Paragon Systems and On Duty Patrol Services, Inc. ODPS has been certified by the U.S. Small Business Administration (the SBA) as a small and disadvantaged business (an 8(a) firm) and is therefore qualified to bid on security contracts specially designated for 8(a) firms. Paragon Systems owns 49% of ODPS. During 2007 and 2008, ODPS did not enter into any contracts.

All significant intercompany transactions have been eliminated.

Certain balances in 2007 and 2006 have been reclassified to conform to the current year presentation.

Liquidity

The Company has historically incurred operating losses and has not yet generated sufficient levels of cash flows from operating activities to meet its scheduled debt service payments and other obligations. The Company has relied on its senior lenders, LSQ Funding Group, L.C. (LSQ) and BRE LLC (BRE and, together with LSQ, the Lenders), to fund operations in excess of the borrowing base formula. Our Lenders and the Company entered into a forbearance agreement through January 1, 2010 that allows for such funding over its borrowing base and waives certain debt covenant defaults. If the balance outstanding under our agreements with our Lenders becomes immediately due and payable, as a result of the subjective acceleration clause or other provisions of the loan agreements, and we are unable to raise significant capital or obtain from our Lenders additional waivers or an additional forbearance agreement, then we will not be able to satisfy our obligations to our Lenders, and our

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Lenders may proceed to foreclose on the collateral and our business and financial condition will be materially and adversely affected.

Additionally, in November 2008, we completed our offer to exchange our outstanding 10% Convertible Promissory Notes due in 2008 (the 10% Notes) for our 14% Convertible Promissory Notes due 2010 (the New Notes) and warrants to purchase shares of our common stock (the Exchange Offer). The Exchange Offer was completed on the terms and conditions set forth in our tender offer statement on Schedule TO, initially filed with the Securities and Exchange Commission on August 20, 2008, as amended. In the Exchange Offer, approximately \$6.6 million, or 86%, of the aggregate principal amount of the 10% Notes was tendered for New Notes and warrants.

The future success of the Company is dependent upon, among other things, our ability to: achieve and maintain satisfactory levels of profitable operations; obtain and maintain adequate levels of debt and/or equity financing; and generate sufficient cash flow from operations to meet current and future debt obligations. We anticipate that, with the recently awarded contracts to Paragon Systems, and the board of director approved initiatives to reduce expenses and the sale of our Cornwall operating unit, along with the forbearance agreement with our Lenders, our cash flows will provide sufficient operating resources through December 31, 2009.

F-7

Table of Contents

Use of Estimates

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

Revenue Recognition

Revenue is recorded monthly as guard services are provided to our customers under contracts. We bill guard services in arrears at hourly or monthly rates based on the number of hours worked under some contracts and at fixed monthly amounts under other contracts. Hourly and monthly rates are based on contractual terms.

The terms of our contracts are complex and may be subject to differing interpretations. We make estimates and judgments about terms of the contracts in providing services and in billing and recording revenue. At times, our Federal contracts require interpretations. Typically, differences in interpretation are resolved on a mutual basis in discussions with the government agency involved. The resolution of differences may result in a determination that amounts previously billed are not in accordance with contract terms and adjustments of amounts initially recorded as revenue may be material.

Contracts with Federal government agencies may be subject to cessation of funding. Cessation of funding may result in amounts billed and recorded as revenue as being uncollectible. We work with the appropriate government agency to resolve funding issues. When funding issues become known, we make estimates and judgments about the extent of potential losses and adjust revenues accordingly. Amounts estimated could differ from amounts ultimately collected and these amounts could be material. During 2008, 2007 and 2006, none of our contracts have been subject to cessation of funding.

Contract losses, if any, are recorded as they become known.

Cost of Revenues

Cost of revenues is primarily comprised of labor, related payroll taxes, employee benefits, workers compensation, liability insurance, and the pro rata portion of the costs of customer contracts acquired.

We make estimates and judgments of amounts recorded for accruals of labor related costs. Expenses most subject to estimation and judgment are accrued vacation and workers compensation costs. The terms of vacation policies may be complex and subject to interpretation. Workers compensation insurance is subject to retroactive audit. Actual amounts could differ from the amounts initially recorded.

Impairment of Long-lived Assets, Goodwill and Intangible Assets

We evaluate impairment of long-lived assets, including property and equipment and intangible assets with finite lives, whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, then an impairment loss is recognized. Measurement of an impairment loss for long-lived assets is based on discounted cash flows and the fair value of an asset.

Table of Contents

We evaluate goodwill and other intangible assets with an indefinite useful life for impairment on an annual basis. Additionally goodwill is tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of an entity below its carrying value. These events or circumstances would include a significant change in the business climate, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business or other factors. The carrying value of goodwill and other intangibles is evaluated in relation to the operating performance and estimated future discounted cash flows of the reporting unit.

During 2008, an impairment charge of \$6.3 million was recorded as goodwill impairment in the consolidated statement of operations included in these consolidated financial statements. See note 8 for additional information.

Investment in Joint Venture

We accounted for our 10% equity in Army Fleet Support LLC (Army Fleet Support), a joint venture which provides logistics support for U.S. Army aviation training at Fort Rucker, Alabama, using the equity method of accounting. Accordingly, our investment in Army Fleet is increased by our share of Army Fleet Support's earnings and reduced by the amortization of our investment in Army Fleet Support and the cash we receive from Army Fleet Support with respect to our investment. During May 2006, we sold our equity interest in Army Fleet Support.

Fair Value of Financial Instruments

Effective January 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157), which clarifies the definition of fair value, prescribes methods for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value, and expands disclosures about fair value measurements. The three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies, is:

Level 1 Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2 Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3 Valuations based on unobservable inputs reflecting our own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, note receivable, accounts payable and accrued liabilities, approximate fair value because of their short maturities.

The carrying amounts of the Company's debt, including our term loan and under our other agreements with our lenders, approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at December 31, 2008 and 2007.

Retirement Plan

Substantially all of Paragon Systems's employees are eligible to participate in a 401(k) profit sharing plan. Under the terms of the plan, employees may elect to defer up to ten percent of their compensation subject to Internal Revenue Service limitations. Paragon Systems may provide discretionary matching contributions on these deferrals each year based upon determinations by our board of directors. Paragon Systems did not make any matching contributions for 2008, 2007 and 2006.

Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

Table of Contents

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are stated at amounts management expects to collect. The allowance for doubtful accounts represents the Company's best estimate of probable losses in the accounts receivable balance. The allowance is based on known troubled accounts, amounts that have been charged back to us by our factor, and other currently available evidence. Accounts that are determined to be uncollectable are written off against the allowance for doubtful accounts.

Property and Equipment

Property and equipment are recorded at cost and depreciated over their estimated useful lives using the double-declining method or the straight line method. Repairs and maintenance costs are expensed as incurred.

Income Taxes

The Company utilizes the liability method of accounting for income taxes, as set forth in SFAS No. 109, *Accounting for Income Taxes*. Under the liability method, deferred taxes are determined based on the difference between the financial and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse and for net operating loss carryforwards. Deferred tax expense or benefit represents the change in the deferred tax asset and liability balances.

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, on January 1, 2007. This standard prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

Stock-based Compensation

On January 1, 2006, we adopted SFAS No. 123R (revised 2004), *Share-Based Payment* (SFAS No. 123R), using the modified-prospective-transition approach method. Under this transition method, compensation costs for 2006 include costs for options, restricted stock and warrants granted prior to, but not vested at, December 31, 2005, and options vested thereafter. Therefore, results for prior periods have not been restated.

Net loss per share

The Company follows SFAS No. 128, *Earnings Per Share*. That statement requires the disclosure of basic net loss per share and diluted net loss per share. Basic net loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per share gives effect to all potentially dilutive securities. The effect of the Company's warrants and stock options were not included in the computation of diluted EPS as their effect was antidilutive.

3. Stock-based Compensation

On December 16, 2004, the FASB issued SFAS No. 123(R), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. The approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, 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 and no longer allows pro forma disclosure as an alternative to financial statement recognition.

Effective January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective method and, therefore, reflects compensation expense in accordance with the SFAS No. 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates.

Table of Contents

In accordance with SFAS No. 123(R), the Company recorded \$831,000, \$236,000 and \$377,000 of stock-based compensation expense for the years ended December 31, 2008, 2007 and 2006, respectively, related to employee stock options, restricted stock and warrants. After recording the expense through December 31, 2008, there remained approximately \$143,000 of unrecognized compensation cost related to unvested employee stock options to be recognized over the next 1.3 years.

We used the Black-Scholes method (which models the value over time of financial instruments) to estimate the fair value at grant date of the options. The Black-Scholes method uses several assumptions to value an option. We used the following assumptions:

Expected Dividend Yield

Expected Volatility in Stock Price reflects the historical change in our stock price over the expected term of the stock option.

Risk-free Interest Rate reflects the average rate on a United States treasury bond with maturity equal to the expected term of the option.

Expected Life of Stock Awards reflects the simplified method to calculate an expected life based on the midpoint between the vesting date and the end of the contractual term of the stock award.

The weighted-average assumptions used in the option pricing model for stock option grants and the resulting fair value were as follows:

Year Ended December 31,	2008		2007		2006	
Expected Dividend Yield						
Expected Volatility in Stock Price	55.69	70.18%	50.19	53.2%	48.91	51.86%
Weighted Average Volatility	56.39%		51.78%		51.79%	
Risk-Free Interest Rate	2.37	2.92%	3.54	4.59%	4.67	5.03%
Expected Life of Stock Awards	5 years		5 years		5 years	
Weighted Average Fair Value at Grant Date	\$	0.74	\$	2.33	\$	1.51

4. Sales to Major Customers

During 2008, 2007 and 2006, 74%, 55% and 46% of the Company's revenue was earned under contracts with various Federal government agencies through its Paragon Systems/SEP subsidiary. At December 31, 2008 and 2007, approximately 70% and 60% of accounts receivable were due from various Federal government agencies, respectively.

5. Related Party Transactions**Employment Agreements**

Pursuant to the employment agreement, as amended, between us and Mr. Farrell, Mr. Farrell has agreed to serve as our Chief Executive Officer and President until June 30, 2010. The agreement provides for (i) payment of a specified base salary which increases by 10% per year; (ii) payment of an annual incentive bonus equal to 5% of our earnings before interest, income taxes, depreciation and amortization, as adjusted (EBITDA) for such year, provided that such bonus may not exceed 100% of Mr. Farrell's base salary for such year; (iii) prohibitions against Mr. Farrell's disclosure of confidential information, solicitation of our employees and participation in a business competitive with our business during his employment and for a period of one year following the termination of his employment; and (iv) continuation of Mr. Farrell's compensation and benefits for the remainder of the term of his employment agreement if his employment is terminated by us without cause or by Mr. Farrell for good reason or upon a change of control of the Company, provided that if a change of control occurs after June 30, 2008 and before July 1, 2010, Mr. Farrell is entitled to receive all monies which he would have been paid under the employment agreement had the term of the agreement terminated on the second anniversary of such change of control rather than on June 30, 2010. Pursuant to Mr. Farrell's employment

Table of Contents

agreement, we also provide certain other benefits and expense reimbursements to Mr. Farrell which are consistent with his position as our Chief Executive Officer. Mr. Farrell is also entitled to participate in any employee benefit plan, stock option plan and other fringe benefit plan at the discretion of the Board.

During 2008, the Company and Mr. Farrell agreed to amend his employment agreement as follows: (i) to reduce his annual salary by (a) 25% during the period from January 1, 2009 through June 30, 2009 and (b) 50% during the period from July 1, 2009 through June 30, 2010; and (ii) to grant to Mr. Farrell (a) 100,000 shares of common stock on the date the amendment to his employment agreement is executed and (b) 81,406 shares of common stock on January 1, 2009. Notwithstanding the foregoing, the reduction in Mr. Farrell's annual salary shall not affect the calculation of bonus, severance or other amounts which Mr. Farrell is entitled to receive, and which are calculated with reference to Mr. Farrell's base salary, under his employment agreement and such bonus, severance and other amounts will be calculated and made as if the reduction in Mr. Farrell's annual salary had not occurred. The stock grants, if made, will be made pursuant and subject to the terms and conditions of the Company's 2004 Stock Incentive Plan, as amended and restated (the "Incentive Plan").

The Company and Mr. Farrell further agreed the stock grants will vest in a manner such that an aggregate of 10,000 shares will vest on the last day of each month during the period from January 1, 2009 through May 31, 2010, and the remaining unvested shares underlying the stock grants will vest on June 30, 2010. Notwithstanding the foregoing, if the Company experiences a change in control (as defined in the Incentive Plan), or if Mr. Farrell resigns, is terminated from his position, ceases to be the Company's Chief Executive Officer or otherwise ceases to be employed by the Company, then all shares underlying the stock grants which have not vested by the end of the month in which such change in control occurs, or at the time of such resignation, termination or cessation, will be forfeited.

During 2007, the Company entered into an employment agreement with Nicolas V. Chater, pursuant to which Mr. Chater has agreed to serve as the Company's Chief Financial Officer until June 30, 2010. Pursuant to the employment agreement, the Company has agreed to pay Mr. Chater for his service as the Company's Chief Financial Officer as follows: (i) a base salary at a rate of \$250,000 per year, (ii) an annual retention bonus equal to \$25,000 per year and (iii) an annual performance bonus equal to 3% of the Company's EBITDA for such year; provided, that (a) the annual performance bonus may not exceed 100% of the base salary for such year and (b) Mr. Chater's 2008 performance bonus shall not be less than \$90,000. The employment agreement also provides that, if Mr. Chater's employment is terminated by the Company without cause or by him for good reason, then Mr. Chater shall be entitled to receive a single lump sum in an amount equal to his then-current salary and performance bonus and shall be entitled to participate in the Company's employee benefit, retirement and compensation plans during the twelve-month period following the date of such termination. Notwithstanding the foregoing, if Mr. Chater's employment is terminated by the Company without cause during the 24-month period following a change of control of the Company, then Mr. Chater will be entitled to receive a lump sum payment of his then-current performance bonus and twice his then-current base salary and shall be entitled to participate in the Company's employee benefit, retirement and compensation plans during the 24-month period following the date of such termination.

The Company has also granted to Mr. Chater, pursuant to the Incentive Plan, an option to purchase 100,000 shares of common stock, with one-half of the underlying shares vesting on each of the first anniversary and the second anniversary of the date of grant. The option has an exercise price equal to the fair market value of our common stock on the date of grant. Subject to availability under the Incentive Plan, the Company has also agreed to grant Mr. Chater an option to purchase up to 50,000 shares of our common stock on each anniversary of the execution of the employment agreement, with such options vesting equally over a two-year period. These options will have an exercise price equal to the fair market value of our common stock on the date of grant. In November 2008, the Compensation Committee of the Board of Directors determined to grant 50,000 restricted shares of our common stock in lieu of such options.

Table of Contents**6. Property and Equipment**

Property and equipment are comprised of the following:

	Estimated Useful Life	December 31, 2008 2007 (in thousands)	
Vehicles	3 - 5 years	48	\$ 48
Computer equipment and software	3 - 5 years	430	397
Field equipment	3 - 5 years	1,190	631
Furniture and fixtures	5 years	171	148
Leasehold Improvements	5 years	32	32
		1,871	1,256
Less accumulated depreciation and amortization		(1,260)	(780)
Property and equipment, net		\$ 611	\$ 476

Depreciation expense for Tri-S was \$480,000, \$375,000 and \$341,000 for the years ended December 31, 2008, 2007 and 2006.

7. Investment in Army Fleet Support, LLC

In conjunction with the acquisition of Paragon Systems on February 27, 2004, the Company acquired a 10% interest in Army Fleet Support. The value of the investment in Army Fleet Support at the acquisition date was \$8,102,000 as established by an independent appraisal. The Company amortized the cost of the investment in excess of the net book value using a 10-year life, which approximated the anticipated length of the contract.

The Company accounted for its investment in Army Fleet Support using the equity method. Accordingly, the investment in Army Fleet Support was increased by the Company's share of Army Fleet Support's earnings and reduced by the amortization of the investment in Army Fleet Support and the cash received from Army Fleet Support.

During May 2006, we sold our 10% equity interest in Army Fleet Support. The details of the transaction are as follows (in thousands):

Cash received	\$ 10,810
Book value of investment	8,907
Gain on sale	\$ 1,903

The investment in Army Fleet Support was effected by the following transactions for the year ended 2006 (in thousands):

Investment in Army Fleet Support beginning	\$ 8,698
Company's share of earnings in Army Fleet Support	659
Amortization of the investment in Army Fleet Support	(275)
Cash received from Army Fleet Support	(175)
Sale of investment in Army Fleet Support	(8,907)
Investment in Army Fleet Support ending	\$

8. Goodwill and Intangible Assets

Intangible assets are summarized as follows (in thousands):

	2008	2007	Amortization Period
Intangible assets:			
Customer Contracts	\$ 6,875	\$ 6,875	1 -9 years
Non-compete agreements	696	696	1 -5 years
Loan Costs	2,818	2,014	1 -3 years
Other	95	95	

F-13

Table of Contents

	2008	2007	Amortization Period
Gross carrying value of intangible assets subject to amortization	10,484	9,680	
Less accumulated amortization:			
Customer Contracts	(5,847)	(4,228)	
Non-compete agreements	(690)	(607)	
Loan Costs	(2,021)	(1,499)	
Other	(95)	(74)	
Accumulated amortization	(8,653)	(6,408)	
Net carrying value of amortizable intangibles	1,831	3,272	
Non-amortizable intangibles:			
Trademarks	659	659	
Goodwill	9,825	16,078	
Total intangibles, net	\$ 12,315	\$ 20,009	

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

Balance, December 31, 2006 and 2007	\$ 16,078
Impairment	(6,253)
Balance, December 31, 2008	\$ 9,825

The Company is required for accounting purposes to assess the carrying value of goodwill and other intangible assets annually or whenever circumstances indicate that a decline in value may have occurred. During 2008, certain of Cornwall's contracts with Miami-Dade County General Services Administration, which represents approximately 37% of Cornwall's revenue, were not renewed. Based on these lost contracts, the Company determined that indicators of potential impairment were present. As a result, the Company, with the assistance of an independent, third-party valuation specialist, assessed the carrying value of acquired goodwill and intangible assets with indefinite lives for impairment, in accordance with Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and Other Intangible Assets using the residual valuation method. The measurement of impairment of goodwill and indefinite life intangibles consists of two steps, which require the Company to determine the fair value of its reporting units and to allocate reporting unit fair value to the individual assets and liabilities. Based on this assessment, we determined approximately \$6.3 million of goodwill at Cornwall was impaired.

The Company does not have tax deductible goodwill.

Amortization of intangible assets for the years ended December 31, 2008, 2007 and 2006 was \$2,245,000, \$2,545,000, and \$2,566,000, respectively.

Estimated future amortization expense for intangible assets on the Company's December 31, 2008 consolidated balance sheet for the fiscal years ending December 31, is as follows (in thousands):

2009	\$ 1,468
2010	332
2011	17
2012	14
	\$ 1,831

Table of Contents**9. Debt and Other Obligations**

The debt of the Company as of December 31, 2008 and 2007 consists of the following (in thousands):

	2008	2007
Short term borrowings under the credit facility	\$ 19,641	\$ 11,625
Term loan, due March 28, 2010	2,500	2,500
10% Notes, face value of \$1,025 bearing interest at 26.1%, cash interest payable monthly at 10% annual rate, due on various dates in September and October 2008	1,025	7,473
14% Notes, face value of \$6,640 bearing interest at 15.6%, cash interest payable monthly at 14% annual rate, due on November 13, 2010	6,470	
Series D Redeemable Preferred Stock, due 2012	1,500	1,500
Total debt	31,136	23,098
Less: current debt	20,666	19,106
Long term debt	\$ 10,470	\$ 3,992

Amended and Restated Credit Agreement

On October 18, 2005, we entered into a Credit Agreement (the "Original Credit Agreement") with our Lenders, pursuant to which we borrowed \$1,650,000 pursuant to a term loan with a maturity date of October 1, 2007 ("Term Loan A") and \$3,500,000 pursuant to a term loan with a maturity date of October 1, 2009 ("Term Loan B" and, together with Term Loan A, the "Term Loans"). During the second quarter of 2006, the Term Loans were paid in full.

In connection with the Original Credit Agreement, we entered into a Factoring and Security Agreement (the "Factoring Agreement") with LSQ, pursuant to which LSQ purchased from us from time to time certain accounts receivable at a discount of 0.7% and provided us with a professional accounts receivable management service for a funds usage fee of the prime rate plus 1.0% on the funds advanced on the outstanding accounts receivable purchased. The Factoring Agreement had a \$6,000,000 initial purchase limit and a four-year term which automatically renewed unless we provided notice of our intent to terminate.

Pursuant to the Original Credit Agreement, we also entered into (i) a Guaranty Agreement pursuant to which we unconditionally and irrevocably guarantee to our Lenders the prompt payment and performance of all of our obligations, indebtedness and liabilities to our Lenders, whether currently existing or subsequently arising (the "Obligations"); and (ii) a Security Agreement, pursuant to which we granted to our Lenders a security interest in substantially all of our assets to secure all of the Obligations. Additionally, we have entered into a Pledge Agreement pursuant to which we pledged to our Lenders the capital stock of Paragon Systems to secure all of our obligations under the Original Credit Agreement and related documents.

On June 27, 2006, Paragon Systems executed a Guaranty of Joint Venture (the "JV Guaranty") pursuant to which Paragon Systems unconditionally guarantees to LSQ the prompt payment and performance of all obligations, indebtedness and liabilities, whether currently existing or subsequently arising, of SEP (the "JV Obligations"). The JV Obligations include the obligations, indebtedness and liabilities of SEP to LSQ under that certain Factoring and Security Agreement between SEP and LSQ dated as of June 27, 2006 (the "JV Factoring Agreement"), pursuant to which LSQ will purchase from SEP from time to time certain accounts receivable at a discount of 0.7% and provide SEP a professional accounts receivable management service for a funds usage fee equal to the prime rate plus 1.0% on the funds advanced on the outstanding accounts receivable purchased. The JV Factoring Agreement has a \$1,000,000 initial purchase limit and a one-year term which will automatically renew unless SEP provides notice of its intent to terminate.

During March 2007, we entered into an Amendment and Forbearance Agreement with our Lenders pursuant to which we amended the Original Credit Agreement and secured an additional \$2.5 million term loan (the "2007 Term Loan") with our Lenders to provide additional financing as needed to provide the capital we estimated was necessary to continue to operate the business during 2007. The 2007 Term Loan matures on March 28, 2010. The 2007 Term Loan bears a 0.25% per month fee on the unused portion of the loan.

Table of Contents

On December 31, 2007, we entered into an Amended and Restated Credit Agreement (the Amended and Restated Credit Agreement) with our Lenders, which amends and restates the Original Credit Agreement. The Amended and Restated Credit Agreement amends and restates the Original Credit Agreement to provide us with a revolving, asset-based lending facility with up to \$25.0 million of borrowing availability, replacing our pre-existing factoring facility with up to \$12.0 million of borrowing availability under the Original Credit Agreement. In connection with entering into the Amended and Restated Credit Agreement, we also entered into (i) a Loan and Security Agreement with LSQ, as may be amended from time to time (the Loan and Security Agreement), and (ii) a Supplemental Agreement to Amended and Restated Credit Agreement with our Lenders (the Credit Agreement Supplement).

The Amended and Restated Credit Agreement continues to provide for the \$2,500,000 2007 Term Loan contemplated by the Original Credit Agreement. Under the Amended and Restated Credit Agreement, interest on the 2007 Term Loan accrues at a rate equal to the prime rate, as published by the Wall Street Journal from time to time (the Prime Rate), plus 4.50% (the Non-Default Rate), but at no time shall the interest rate be less than 11.25% per annum. If an event of default under the Amended and Restated Credit Agreement occurs, then interest accrues on the 2007 Term Loan at a rate equal to the Non-Default Rate plus 5% and certain other default fees specified in the Amended and Restated Credit Agreement would become due and payable. The 2007 Term Loan requires us to pay a Minimum Balance Fee, as described in the Amended and Restated Credit Agreement, if the 2007 Term Loan is repaid prior to maturity.

Pursuant to the Loan and Security Agreement, at our request, LSQ shall make advances (Advances) to us not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable through March 31, 2009 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of (i) billed accounts receivable at a rate equal to the Prime Rate plus 1% (but not less than 11%) and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5% (but not less than 12%). In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%. The Loan and Security Agreement includes a subjective acceleration clause and expires on October 31, 2010.

Under the Credit Agreement Supplement, anytime the 2007 Term Loan is outstanding and so long as unbilled accounts receivable are included in the borrowing base for purposes of making Advances, we must pay a monthly fee to our Lenders equal to 2.25% of the highest daily overadvance amount (which is the highest daily amount in any given month calculated as the outstanding 2007 Term Loan plus all outstanding Advances less the borrowing base) less (ii) \$60,000 or such lesser amount as will reduce the overadvance fee to zero. In addition, the Credit Agreement Supplement requires that we issue to our Lenders a four-year warrant to purchase 30,000 shares of common stock, at an exercise price of \$3.00 per share, for each month in which an overadvance under the Loan and Security Agreement exists. In no event shall such warrants issued to Lenders under the Credit Agreement Supplement be exercisable in the aggregate for greater than 420,000 shares of common stock.

All of our obligations under the Amended and Restated Credit Agreement and the Loan and Security Agreement are secured by a first priority security interest in all of our assets and a pledge of all of the equity interests in our subsidiaries.

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2008, is approximately \$22.7 million. Additionally, from time to time during 2008, we have borrowed more than the maximum amount allowable under the availability formula under the Amended and Restated Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, we were not in compliance with the Amended and Restated Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, we entered into an Amendment and Forbearance Agreement, as amended from time to time (the Forbearance Agreement), with our Lenders. Pursuant to the Forbearance Agreement, our Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forbear from exercising all remedies available to them in connection with such existing defaults until the earlier of (i) a potential equity or subordinated debt offering by us or (ii) January 1, 2009. On December 12, 2008, the Forbearance Agreement was amended to extend the end of the forbearance period from January 1, 2009 to January 1, 2010.

Table of Contents

If an event of default under the Amended and Restated Credit Agreement or any agreement we have with our Lenders occurs, then the entire balance outstanding under all such agreements shall become immediately due and payable. We will not be able to repay this balance unless we raise significant capital by selling assets or issuing debt or equity securities, which we may not be able to do on terms acceptable to us, if at all. If the balance outstanding under our agreements with our Lenders becomes immediately due and payable and we are unable to raise significant capital or obtain from our Lenders an additional waiver and an agreement to forbear, then we will not be able to satisfy our obligations to our Lenders, our Lenders may proceed to foreclose on the collateral and our business and financial condition will be materially and adversely affected.

Convertible Notes

During September and October 2005, we issued in a private placement transaction the 10% notes with an aggregate principal amount of \$8,015,000 and warrants to purchase 834,896 shares of common stock for a total purchase price of \$8,015,000. The 10% Notes and warrants were issued in four closings between September 2, 2005 and October 14, 2005. The face value of the 10% Notes was \$8,015,000 upon issuance. Interest is payable monthly on the face value of the 10% Notes at a rate of 10% per annum. The gross proceeds from the offering of 10% Notes and warrants was allocated to the 10% Notes and warrants in accordance with Emerging Issue Tax Force 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* (EITF 98-5). In accordance with EITF 98-5, \$6,107,000 of the gross proceeds was allocated to the 10% Notes and \$1,908,000 was allocated to additional paid in capital related to the warrants and the beneficial conversion feature. The conversion of the 10% Notes was restricted at the issue date because of the need for a shareholder vote to approve the contingently issuable shares as well as certain other restrictions. In February 2006, the shareholders approved the shares issuable upon conversion of the 10% Notes. Accordingly, approximately \$1.1 million of the in-the-money beneficial conversion feature was recorded to increase the book value of the 10% Notes. Of the \$1.1 million of in-the-money beneficial conversion feature, approximately \$700,000 was recorded as interest expense during the second quarter 2006 and approximately \$426,000 was recorded as a reduction to additional paid in capital because of additional conversion restrictions associated with a certain portion of the 10% Notes. During the third quarter 2007, the 10% Notes subject to conversion restrictions became convertible. Accordingly, approximately \$426,000 was recorded as interest expense and as an increase to paid in capital. The remaining discount on the 10% Notes relative to face value will be amortized to interest expense over the remaining life of the 10% Notes.

The 10% Notes are convertible by the holders at an initial conversion price of \$4.80 per share subject to certain restrictions. The warrants issued in the private placement expired in September and October of 2008.

The 10% Notes with an outstanding principal balance of approximately \$7.6 million matured in September and October 2008. On November 13, 2008, we completed the Exchange Offer in which approximately \$6.6 million, or 86%, of the aggregate principal amount of the 10% Notes was tendered for New Notes and warrants.

On December 16, 2008, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$25,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 2,604 shares of our common stock at an exercise price of \$0.75 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$25,000, which matured in September 2008, previously issued by us to such investor.

On January 8, 2009, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$37,500, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 3,906 shares of common stock at an exercise price of \$0.95 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$37,500, which matured in October 2008, previously issued by us to such investor.

Table of Contents

On February 3, 2009, we issued to an accredited investor: (i) a promissory note with a principal amount of \$50,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 5,208 shares of our common stock at an exercise price of \$0.75 per share. The investor agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$50,000, which matured in October 2008, previously issued by us to such investor.

Redeemable Preferred Stock

The Series C Redeemable Preferred Stock was classified as preferred shares subject to mandatory redemption in the financial statements. On September 13, 2007, we entered into a Settlement Agreement and General Release (the Paragon Settlement Agreement), among the Company, Paragon Systems, and Ronald G. Farrell, our Chief Executive Officer, on the one hand, and Charles Keathley, Robert Luther, John Wilson and Harold Bright, on the other hand (collectively, the Selling Shareholders), with respect to all of the litigation pending among the Company, Paragon Systems, Mr. Farrell and the Selling Shareholders (collectively, the Paragon Litigation). As a result of the Paragon Settlement Agreement, we cancelled the shares of the Series C Redeemable Preferred Stock held by the Selling Shareholders. Holders of the Series C Redeemable Preferred Stock had no voting rights, except that a consent of a majority of the holders of the Series C Redeemable Preferred Stock, voting separately as a class, was required to increase or decrease the number of authorized shares of Series C Redeemable Preferred Stock and except as otherwise required by applicable law. The Series C Redeemable Preferred Stock did not have any preemptive, conversion or sinking fund rights nor did it have any rights or preferences in the event of a liquidation, dissolution or winding-up of the Company.

Also, on September 13, 2007, as a result of the Paragon Settlement Agreement, the Company issued to the Selling Shareholders an aggregate of 700,000 shares of common stock and an aggregate of 100 shares of Series D Redeemable Preferred Stock, which (a) have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012 or the date on which the Company sells 70% or more of its assets in one or more transactions (unless the proceeds from such sale are reinvested in the Company's business, used to restructure debt or used for acquisitions or working capital purposes), and (b) accrue dividends of \$750 per share per annum and are payable quarterly.

Future Minimum Debt Payments

The future minimum debt payments are as follows (in thousands):

2009	\$ 20,666
2010	8,970
2011	
2012	1,500
	\$ 31,136

10. Income Taxes

The benefit for income taxes consisted of the following for the years ended December 31, 2008, 2007 and 2006 (in thousands):

	2008	2007	2006
Current	\$ 87	\$ 664	\$ (1,406)
Deferred	3,312	2,456	3,100
(Increase)/Decrease in Valuation Allowance	(3,312)	(482)	
Income tax benefit	\$ 87	\$ 2,638	\$ 1,694

Table of Contents

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and for net operating loss carryforwards. The significant components of deferred tax assets and liabilities as of December 31, 2008 and 2007, are as follows (in thousands):

	2008	2007
Deferred tax assets:		
Net operating loss carryforward	\$ 3,579	\$ 1,335
Allowance for doubtful accounts	328	
Investment in Southeastern Paragon	277	177
Accrued expenses & other	162	108
Total deferred tax assets	\$ 4,346	\$ 1,620
Valuation Allowance	(3,794)	(482)
Net deferred tax assets	\$ 552	\$ 1,138
Deferred tax liabilities:		
Depreciation and amortization	\$ (552)	\$ (1,134)
IRC cash to accrual adjustment		(4)
Total deferred tax liabilities	(552)	(1,138)
Net deferred income tax assets / (liabilities)	\$	\$

At December 31, 2008, the Company had cumulative gross federal income tax net operating loss (NOL) carryforwards of approximately \$8.1 million available to reduce future amounts of taxable income, the majority of which was created as a result of the consolidated 2007 and 2008 operations. If not utilized to offset future taxable income the current NOL will expire between 2027 and 2028. Additionally, the Company acquired through the Cornwall acquisition unused federal NOLs. Under Internal Revenue Code section 382, there is an annual limitation on the use of the NOLs acquired from Cornwall. If not utilized to offset future taxable income, the cumulative NOL amount will expire from 2020 through 2025. The Company also had approximately \$825,000 of tax effected state NOLs. If not utilized to offset future state taxable income, the state NOLs will expire between 2020 and 2028. For 2008, management has recorded a total valuation allowance of \$3.8 million against its deferred tax assets including the NOL s.

A reconciliation of the income tax provision computed at statutory tax rates for the years ended December 31, 2008, 2007 and 2006, is as follows:

	2008	2007	2006
Income tax benefit at statutory rate	34.0%	34.0%	34.0%
State income taxes, net of federal benefit	2.4	5.6	3.6
Goodwill impairment loss	(13.3)		
Preferred stock dividends		(1.0)	(1.9)
Stock option compensation	(1.8)	(1.2)	(2.3)
Resolution of income tax uncertainties from prior year		(1.3)	(2.3)
Stock acquisition basis adjustments		11.4	
Valuation Allowance	(20.7)	(7.0)	
Non-deductible expenses and other			(0.4)
Income tax benefit	.6%	40.5%	30.7%

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

We adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48) on January 1, 2007. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition

F-19

Table of Contents

issues. The adoption of FIN 48 resulted in the recognition of \$32,104 of penalties which was recorded as an adjustment to the January 1, 2007 retained earnings. No adjustments were made in the fourth quarter 2008 to the balance of unrecognized tax benefits and no material change is expected in the next twelve months. In addition, the following information required by FIN 48 is provided:

As noted above, as of January 1, 2007, we have accrued penalties in the amount of \$32,104 related to uncertain tax positions. As of December 31, 2008, the total amount of interest and penalties accrued was approximately \$184,000. Accrued interest on tax deficiencies and tax penalties are recorded as a component of income tax expense.

The recognition of unrecognized tax benefits will not impact the Company's effective tax rate.

The Company and its subsidiaries file federal income tax returns, as well as multiple state and local tax returns. The tax years of 2005 to 2007 for all jurisdictions remain open to examination.

11. Lease Obligations

Operating Leases

The Company leases real property and equipment under operating leases. Lease expense was \$1,211,000, \$1,186,000 and \$1,033,000 for 2008, 2007 and 2006, respectively.

Future Minimum Operating Lease Payments

Future minimum rental payments required under the operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2008 are as follows (in thousands):

2009	\$ 908
2010	525
2011	354
2012	84
2013	20
Total	\$ 1,891

12. Preferred and Common Stock

Immediately prior to the initial public offering of our common stock on February 9, 2005, we entered into an exchange and recapitalization agreement with all of the holders of common stock, convertible preferred stock and holders of rights to acquire common stock. Pursuant to the agreement, we implemented a reverse stock split of all the outstanding shares of its common stock and stock options and exchanged common stock for all Series A and B Convertible Preferred Stock. The recapitalization was given retroactive treatment in the financial statements and related disclosures.

On September 13, 2007, as a result of the Paragon Settlement Agreement, we cancelled the shares of the Series C Redeemable Preferred Stock held by the Selling Shareholders. Holders of the Series C Redeemable Preferred Stock had no voting rights, except that a consent of a majority of the holders of the Series C Redeemable Preferred Stock, voting separately as a class, was required to increase or decrease the number of authorized shares of Series C Redeemable Preferred Stock and except as otherwise required by applicable law. The Series C Redeemable Preferred Stock did not have any preemptive, conversion or sinking fund rights nor did it have any rights or preferences in the event of a liquidation, dissolution or winding-up of the Company.

The Series D Preferred Stock is discussed in Note 9.

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

We are authorized to issue 25 million shares of common stock with a par value of \$0.001 per share. The holders of common stock are entitled to one vote per share on all matters. Our common stock does not have cumulative voting rights and no conversion rights. Each share of common stock has an equal and ratable right to receive dividends to be paid from assets legally available when and if declared by our board of directors. We have never paid any cash dividends on common stock.

F-20

Table of Contents

During the first quarter of 2006, we issued 20,000 shares of our common stock for services at a price of \$4.45 per share. We recorded expense of approximately \$89,000 related to the shares issued for services.

During the second quarter of 2006, we issued 20,000 shares of our common stock at a price of \$4.55 per share to one of the former shareholders of Cornwall pursuant to an employment agreement entered into with such shareholder in connection with the acquisition of Cornwall. Also, during the second quarter of 2006, we issued 62,500 shares of our common stock upon conversion of a 10% Note with an outstanding principal amount of \$300,000 and a book value of \$240,000. During the first quarter of 2006, we issued 10,417 shares of our common stock upon conversion of a 10% Note with an outstanding principal amount of \$50,000 and a book value of \$39,300.

During 2008, we granted 125,000 shares of restricted stock valued at \$2.46 per share, 80,000 shares of restricted stock valued at \$0.65 per share, and 100,000 shares of restricted stock valued at \$0.55 per share. These restricted shares vest evenly over a three-year period. In accordance with SFAS No. 123(R), the Company recorded approximately \$77,000 of expense related to these restricted shares. This amount is included in total stock compensation expense reported in note 3, stock-based compensation. After recording the expense through December 31, 2008, there remains approximately \$338,000 of unrecognized compensation cost related to unvested restricted stock to be recognized over the next 2.3 years.

13. Common Stock Options and Warrants

On February 8, 2005, we completed a public offering of 2,070,000 units (including the exercise of the over-allotment option) consisting of one share of common stock and one warrant to purchase common stock at \$6.00. The net proceeds of the offering totaled \$10,887,000.

In conjunction with the initial public offering, we sold an option to purchase 180,000 shares (Share Option) of our common stock and an option to purchase 180,000 warrants (Warrant Option) for \$180. The Share Option became exercisable 180 days after the IPO at an exercise price of \$5.00 per share. The Warrant Option became exercisable 180 days after the IPO at an exercise price of \$0.15 per share. The warrants underlying the Warrant Option became exercisable 180 days after the IPO at an exercise price of \$6.00 per share.

In conjunction with the financing for the Cornwall acquisition, we issued warrants to purchase 1,260,365 shares of common stock exercisable at \$4.80 per share, of which warrants to purchase 834,896 shares of common stock were issued to the purchasers of the 10% Notes, warrants to purchase 250,469 shares of common stock were issued to the placement agent underwriters of the 10% Notes offering and warrants to purchase 175,000 shares of common stock were issued to our Lender.

Non-qualified stock options for 97,087 shares of common stock were granted on January 1, 2002 with an exercise price of \$0.12 per share. These options vested 32,362 shares each on December 31, 2004, 2003 and 2002 and expire in October 2011. During 2006, the options for 97,087 shares were exercised. As of December 31, 2007, there have been no other options granted and there have been no options forfeited.

The Incentive Plan was approved and adopted by our board of directors and shareholders on October 13, 2004, and was amended and restated by shareholder approval in November 2006 and further amended by shareholder approval in December 2008. The Incentive Plan is administered by the compensation committee of our board of directors in accordance with and subject to the provisions of the Incentive Plan. The committee has the authority to determine all provisions of incentive awards as the committee may deem necessary or desirable and as consistent with the terms of the Incentive Plan. The Incentive Plan will terminate at midnight no later than October 13, 2014, unless terminated earlier by action of our board of directors.

The Incentive Plan provides for the grants of incentive awards to eligible participants, including employees, officers, directors, consultants and independent contractors. These awards may include options to purchase shares of common stock that qualify as incentive stock options within the meaning of the Internal Revenue Code, non-qualified options, restricted stock awards, and stock bonuses.

Table of Contents

The per share price to be paid by a participant upon exercise of an option is determined by the committee at the time of the option grant, provided that the exercise price for incentive stock options must be equal to the fair market value of common stock on the date of grant and 110% of the fair market value if, at the time the incentive stock option is granted, the participant owns, directly or indirectly, more than 10% of the total combined voting power of all classes of stock of the Company or any parent or subsidiary corporation of the Company. An option will become exercisable at such times and in such installments as may be determined by the committee in its sole discretion at the time of grant, provided that no option may be exercisable after 10 years from its date of grant.

The following table summarizes employee stock option activity for the years ended December 31, 2008, 2007 and 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Outstanding at December 31, 2005	340,587	\$ 3.29	
Granted	216,500	2.99	\$ 1.50
Exercised	(97,087)	0.12	
Canceled or Expired	(8,300)	3.00	
Outstanding at December 31, 2006	451,700	3.83	
Granted	460,000	2.33	\$ 1.15
Exercised			
Canceled or Expired	(372,850)	3.42	
Outstanding at December 31, 2007	538,850	2.84	
Granted	462,500	2.41	\$ 1.22
Exercised			
Canceled or Expired	(128,300)	3.39	
Outstanding at December 31, 2008	873,050	2.53	

A summary of the status of our nonvested stock options as of December 31, 2008 and changes during the year ended December 31, 2008, is presented below.

	Shares	Weighted- Average Grant- Date Fair Value
Nonvested at January 1, 2008	340,900	\$ 2.56
Granted	220,000	2.50
Vested	(66,017)	3.18
Forfeited	(58,867)	3.21
Nonvested at December 31, 2008	436,016	2.35

As at December 31, 2008, there was approximately \$143,000 of unrecognized compensation cost related to unvested stock options granted. We expect to recognize this cost over the next 1.3 years.

Options exercisable at December 31, 2008 and 2007 were 437,034 and 197,950, respectively.

The following table summarizes additional information about employee stock options outstanding at December 31, 2008:

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Range of Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2008	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2008	Weighted Average Exercise Price
\$0.65-4.27	873,050	9 years	\$ 2.53	437,034	\$ 2.60

F-22

Table of Contents

The following table summarizes the warrants outstanding for the years ended December 31, 2008 and 2007.

	2008	2007	Weighted Average Exercise Price
Warrants issued and outstanding related to IPO	2,430,000	2,430,000	\$ 6.18
Warrants issued and outstanding related to issuance of 10% Notes Payable		1,085,365	\$ 4.80
Warrants issued and outstanding related to Credit Agreement	175,000	175,000	\$ 4.80
Warrants issued and outstanding related to Amendment to Loan and Security Agreement	365,000		\$ 2.41
Warrants issued and outstanding related to the Tender Offer of 14% Convertible Notes	1,177,026		\$ 1.35
Total warrants outstanding	4,147,026	3,690,365	

Restricted stock awards are awards of common stock granted to a recipient which are subject to restrictions on transferability and the risk of forfeiture. The compensation committee may impose such restrictions or conditions to the vesting of restricted stock awards, including that the participant remain in the continuous employ or service of the Company for a specified period of time or that the participant or the Company satisfy specified performance goals or criteria.

Stock bonuses are awards of common stock that are not subject to any restrictions other than, if imposed by the committee, restrictions on transferability. Stock bonuses are subject to such terms and conditions as may be determined by the committee.

14. Sale of Certain Home Monitoring Customer Contracts of International Monitoring, Inc.

On July 21, 2006, International Monitoring, Inc., a wholly-owned subsidiary of Cornwall, sold substantially all of its operating assets, including certain home monitoring customer contracts, to an unrelated purchaser for a purchase price of approximately \$680,000, subject to a 10% reduction thereof for customer attrition. Additional customer contracts will be sold to the purchaser if certain provisions are met which qualify such contracts. In addition, the purchaser will service all accounts not sold under a separate servicing agreement.

The details of the transaction are as follows:

Cash received (adjusted for customer attrition)	\$ 607,823
Book value of assets sold	130,285
Gain on sale	\$ 477,538

15. Cornwall Settlement

At the closing of our acquisition of Cornwall (see Note 2), we paid a total purchase price of \$13,500,000 payable as follows: (i) payment of \$12,825,000 in cash; (ii) delivery of a promissory note in principal amount of \$250,000 payable to the former Cornwall shareholders (the Cornwall Promissory Note); and (iii) deposit of \$425,000 with an escrow agent to secure the indemnification obligations of the former Cornwall shareholders under the Stock Purchase Agreement between us and the former Cornwall shareholders dated as of August 11, 2005 (the Cornwall Purchase Agreement). After adjusting for certain working capital items, the net purchase price was \$12,753,000. On January 26, 2007, we entered into

Table of Contents

a Settlement Agreement and General Release (the Cornwall Settlement Agreement) with David Shopay, on behalf of himself and the other former shareholders of Cornwall, in his capacity as the representative of such shareholders. Pursuant to the Cornwall Settlement Agreement (i) the parties waived and released each other from all claims and liabilities, with the exception of certain claims and liabilities specified in the Cornwall Settlement Agreement, arising from the Cornwall Purchase Agreement; (ii) the shareholder representative forgave and discharged all amounts owed by us to the former shareholders of Cornwall under the Cornwall Promissory Note; and (iii) the shareholder representative and the Company instructed the escrow agent administering the escrow fund to release \$200,000 from such fund to us and the remaining balance of such fund to the former shareholders of Cornwall. We recognized a gain of \$450,000 as other income on the accompanying statements of operations for the year ended December 31, 2007.

16. Contingencies

We are involved in various legal proceedings, including employee discrimination suits, from time to time in the normal course of business. In management's opinion, we are not currently involved in any legal proceedings, individually or in the aggregate, which could have a material effect on the financial condition, results of operations or cash flows of the Company.

17. Litigation

Legal Proceedings

Except as set forth below, we believe that, based on currently known facts, there are no claims or litigation pending against us the disposition of which would materially affect our financial position or future operating results, although we cannot be certain as to the ultimate outcome of any such claim or litigation. In addition, exposure to litigation is inherent in our ongoing business and may harm our business in the future.

Litigation with the Former Shareholders of Paragon Systems

On September 13, 2007, we entered into the Paragon Settlement Agreement, pursuant to which:

- (i) the Company paid the Selling Shareholders an aggregate of \$1,250,000;
- (ii) the Selling Shareholders and the Company cancelled the shares of the Series C Redeemable Preferred Stock held by the Selling Shareholders, which shares had an aggregate redemption value of \$6,000,000;
- (iii) the Selling Shareholders terminated and released their security interest in the outstanding shares of capital stock of Paragon Systems;
- (iv) the Company issued to the Selling Shareholders an aggregate of 700,000 shares of our common stock and an aggregate of 100 shares of Series D Redeemable Preferred Stock, which (a) have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012 or the date on which the Company sells 70% or more of its assets in one or more transactions (unless the proceeds from such sale are reinvested in the Company's business, used to restructure debt or used for acquisitions or working capital purposes) and (b) accrue dividends of \$750 per share per annum, payable quarterly;
- (v) the Company agreed not to amend Mr. Farrell's employment agreement with the Company to increase or enhance the compensation or benefits payable to him thereunder until September 13, 2008;
- (vi) the Company agreed to issue to the Selling Shareholders an aggregate of 10% of any equity securities of the Company which are issued to Mr. Farrell during the period commencing on May 18, 2007 and ending on May 18, 2008;
- (vii) the Selling Shareholders, pursuant to a Voting Agreement, granted to Mr. Farrell a proxy to vote, in his sole and absolute discretion, an aggregate of 700,000 shares of common stock held by the Selling Shareholders until such time as such shares are sold by them to an unaffiliated party in accordance with the terms of the Securities Act of 1933, as amended;

Table of Contents

(viii) the Company agreed to indemnify the Selling Shareholders for costs and expenses incurred by them relating to the litigation pending against the Company in the United States District Court for the Northern District of Georgia regarding the Company's initial public offering; and

(ix) the Company, Paragon Systems and the Selling Shareholders released each other from all claims and obligations among them existing as of September 13, 2007 (except for obligations arising pursuant to the terms of the Settlement Agreement) and have caused the Litigation to be dismissed with prejudice.

In connection with the Settlement Agreement, (i) the portion of the Litigation pending in the Circuit Court for Madison County, Alabama, was dismissed with prejudice on October 5, 2007; (ii) the portion of the Litigation relating to the demand for arbitration and statement of claim pending before the American Arbitration Association was closed on September 26, 2007; and (iii) the portion of the Litigation pending in the United States District Court, Northern District of Georgia, Atlanta Division, was dismissed with prejudice on September 28, 2007.

Litigation Regarding Our Initial Public Offering

As previously disclosed, on November 1, 2006, a purported class action complaint was filed in the State Court of Fulton County, State of Georgia, against Tri-S, its Chief Executive Officer, its former Chief Financial Officer and the lead underwriters in Tri-S's initial public offering, alleging, among other things, violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, in connection with Tri-S's initial public offering (*Unschuld v. Tri-S Security Corp., et al.*, the Unschuld Litigation). More specifically, the complaint alleges that the registration statement relating to the initial public offering was materially inaccurate and misleading because it failed to disclose certain problems with the operations and financial condition of Paragon Systems of which the complaint alleges we were aware. The complaint seeks class certification, unspecified compensatory damages or rescission, as appropriate, and costs and disbursements relating to the lawsuit, including reasonable attorneys' fees. On December 1, 2006, Tri-S removed the lawsuit to the United States District Court for the Northern District of Georgia. Plaintiff moved to remand the case back to the state court, which motion was granted on September 14, 2007, and the case is now pending in the State Court of Fulton County, State of Georgia. Tri-S and the other defendants each filed answers in response to the Complaint on August 13, 2008. On that same date, they also filed a joint motion to dismiss, or in the alternative, a motion for judgment on the pleadings (the Motion to Dismiss) and a motion for a stay of discovery (the Motion for Stay) pending a decision on the Motion to Dismiss. Plaintiff opposed the Motion for Stay on October 8, 2008 and the Motion to Dismiss on October 16, 2008. The Court stayed proceedings in the action until March 9, 2009 because of the parties' on-going settlement discussions. On March 9, 2009, the parties filed a Joint Stipulation of Settlement and Release (the Settlement Agreement). The Court granted preliminary approval to the Settlement Agreement on March 10, 2009 (the Preliminary Approval Order). The Preliminary Approval Order (i) certified on a provisional basis a class of purchasers of certain Tri-S units, common stock, and warrants and (ii) scheduled a fairness hearing for June 1, 2009. Notice of the proposed settlement will be sent to potential class members and the class administrator will administer the notice and payment process. Under the terms of the Settlement Agreement and the Preliminary Approval Order, a payment of \$1,000,000 was made (on behalf of all defendants) on March 20, 2009 (the Cash Settlement Payment) in return for, among other things, a release and dismissal with prejudice of all claims against us and the other defendants. Our insurance carrier funded the Cash Settlement Payment. The final approval of the Settlement Agreement is subject to the satisfaction of certain conditions, including, without limitation, the entry by the Court of a final order approving the Settlement Agreement. If such final approval is not obtained, then the Settlement Agreement will become null and void.

On December 10, 2007, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Axis Reinsurance Company and Axis Insurance Company (collectively Axis) for declaratory and injunctive relief. Axis issued a Directors, Officers, and Corporate Liability Insurance Policy to Tri-S for the period from March 13, 2006 to March 13, 2007 (the Axis Policy). Tri-S provided notice of the Unschuld Litigation to Axis on November 8, 2006. On November 9, 2007, attorneys for Axis informed Tri-S that Axis disclaimed coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that coverage for the Unschuld Litigation is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems and that Axis is required to advance defense costs incurred in connection with the Unschuld Litigation and (ii) an order requiring Axis to advance such defense costs. On April 11, 2008, Tri-S moved to dismiss Axis Insurance Company from the action without prejudice. The Court granted the motion on April 15, 2008. Axis Reinsurance Company removed the case to the United States District Court for the Northern District of Georgia on April 16, 2008 and filed an answer in that court on April 23, 2008. The parties stipulated to a voluntary dismissal of the action without prejudice on June 11, 2008 and the case was dismissed on June 12, 2008.

Table of Contents

On March 13, 2008, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Capitol Specialty Insurance Corporation (Capitol), McGriff, Seibels & Williams of Georgia, Inc. and McGriff, Seibels & Williams, Inc. (collectively, McGriff), seeking declaratory relief and damages. McGriff acted as Tri-S's broker in obtaining the Axis Policy. Capitol issued a Directors and Officers Liability Insurance Policy to Tri-S for the period from February 9, 2005 to March 13, 2006 (the Capitol Policy). Tri-S provided notice under the Capitol Policy of the Unschuld Litigation on December 13, 2007. Coverage under that policy was denied on January 25, 2008. In the event that the Unschuld Litigation is not covered under the Axis Policy, Tri-S is seeking (i) a declaration that the Capitol Policy requires Capitol to advance defense costs in connection with the Unschuld Litigation; (ii) an order requiring Capitol to advance such defense costs; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for any such loss. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy in connection with the Unschuld Litigation, Tri-S is seeking (a) damages, in an amount to be determined at trial, against McGriff for negligence, breach of contract, negligence per se, negligent procurement, negligent misrepresentation, professional negligence, and breach of fiduciary duty; (b) a declaration that McGriff is required to cover any loss as defined in the Axis Policy that Tri-S incurs in connection with the Unschuld Litigation up to the limit of liability of the Axis Policy; and (c) an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. On April 11, 2008, Tri-S voluntarily dismissed the action without prejudice.

On May 13, 2008, Tri-S filed a complaint in the Superior Court of Fulton County, State of Georgia against Axis Reinsurance Company, Capitol, and McGriff combining Tri-S's claims related to coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that the Axis Policy provides coverage for loss incurred in connection with the Unschuld Litigation and that coverage is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems or by any other provision of the policy; (ii) an order requiring Axis to advance defense costs incurred in connection with the Unschuld Litigation; and (iii) an order requiring Axis to cover loss for claims related to the Unschuld Litigation. In the alternative, and to the extent the Unschuld Litigation is not covered by the Axis Policy, Tri-S seeks (i) a declaration that the Capitol Policy requires Capitol to pay defense expenses in connection with the Unschuld Litigation; (ii) an order requiring Capitol to pay such defense expenses; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for such loss. Tri-S also seeks damages against McGriff for negligence, breach of contract, and breach of fiduciary duty in an amount to be determined. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy, Tri-S further seeks a declaration that McGriff is required to cover loss incurred in connection with the Unschuld Litigation and an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. Axis answered the complaint and asserted affirmative defenses on June 11, 2008. Capitol answered the complaint and asserted affirmative defenses on July 17, 2008. The parties agreed to extend McGriff's time to answer through and including April 24, 2009.

Dispute with Miami-Dade General Services Administration

As previously disclosed, a search warrant was issued on January 17, 2008, by the Circuit Court of the eleventh judicial circuit in and for Miami-Dade County, Florida, to search the premises of Forestville Security, a subsidiary of Cornwall based in Miami, Florida, for any and all records or documents pertaining to the contract between Forestville Security and Miami-Dade General Services Administration for the period of April 1, 2005 to August 1, 2007. The search warrant states that Miami-Dade General Services Administration alleges that it has uncovered instances of fraudulent billing committed by Forestville Security in connection with the Miami-Dade General Services Administration contract. Forestville Security is fully cooperating with the authorities regarding the investigation.

We made a settlement offer of \$555,000 to Miami Dade County, which is fully reserved as of December 31, 2008, and believe we have reached an agreement in principle to settle the matter. This settlement offer is subject to the approval of the Board of County Commissioners. On April 7, 2009 the settlement was approved by the Miami-Dade County Commission.

Table of Contents**18. Segment Information**

The Company's two reportable segments are Cornwall and Paragon Systems/SEP. The accounting policies applicable to these reportable segments are the same as those described in the summary of significant accounting policies. The Cornwall segment focuses on contract guard services to commercial and state and local government customers. The Paragon Systems/SEP segment focuses on contract guard services to various Federal government agencies.

We considered our organization and reporting structure and the information used by our chief operating decision makers to make decisions about resource allocation and performance assessment and determined management evaluates the performance of the segments based primarily on revenues and operating income (loss). Revenues, operating income, and assets for each segment are as follows (in thousands):

	Total	Cornwall	Paragon Systems/SEP	Other
2008				
Revenues	\$ 141,332	\$ 36,974	\$ 104,358	\$
Amortization and depreciation	2,725	1,590	620	515
Goodwill impairment	6,253	6,253		
Operating (loss) income	(11,018)	(7,494)	985	(4,509)
Interest expense, net	4,966	1,257	1,311	2,398
Current assets	18,834	5,271	13,320	243
Goodwill	9,825	2,078	7,747	
Other intangibles	2,490	1,665	28	797
Total assets	31,760	9,028	21,656	1,076
2007				
Revenues	\$ 88,943	\$ 39,951	\$ 48,992	\$
Amortization and depreciation	2,920	1,711	506	703
Operating loss	(6,825)	(1,267)	(1,376)	(4,182)
Interest expense, net	2,665	645	412	1,608
Current assets	15,159	6,185	8,963	11
Goodwill	16,078	8,331	7,747	
Other intangibles	3,931	3,061	378	492
Total assets	35,644	17,773	17,315	556
2006				
Revenues	\$ 75,725	\$ 40,875	\$ 34,850	\$
Amortization and depreciation	2,907	1,808	424	675
Operating loss	(5,132)	(252)	(1,004)	(3,876)
Interest expense, net	3,434	582	439	2,413
Current assets	14,028	6,260	7,742	26
Goodwill	16,078	8,331	7,747	
Other Intangibles	6,398	4,530	725	1,143
Total assets	37,101	19,494	16,367	1,240

19. Selected Quarterly Financial Data (Unaudited)

The following table sets forth, for each quarter in the last three fiscal years, selected data from our statements of operations.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(in thousands, except per share data)				
2008, as previously reported				
Revenue	\$ 26,465	\$ 38,346	\$ 40,697	\$ 35,824
Gross profit	2,224	3,245	3,530	2,182
Goodwill impairment			4,040	2,213
Net loss attributable to common shareholders	(1,815)	(1,486)	(5,786)	(5,031)

Edgar Filing: TRI-S SECURITY CORP - Form 10-K

Basic and diluted net loss per share attributable to common shareholders	(0.43)	(0.35)	(1.38)	(1.20)
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share data)			
2008, as restated				
Revenue	\$ 26,465	\$ 38,346	\$ 40,697	\$ 35,824
Gross profit	1,911	2,917	3,240	1,387
Goodwill impairment			4,040	2,213
Net loss attributable to common shareholders	(2,129)	(1,815)	(6,077)	(5,827)
Basic and diluted net loss per share attributable to common shareholders	(0.51)	(0.43)	(1.45)	(1.39)

During the second quarter of 2009, the Company's audit committee (the "Audit Committee") of Tri-S Security Corporation (the "Company") determined, upon advice of management, that the Company's consolidated financial statements and related disclosures included in the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30, and September 30, 2008 (collectively, the "Previously Issued Financial Statements"), should be restated because they contain errors as addressed in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*. Accordingly, the Previously Issued Financial Statements and the earnings releases issued by the Company for the quarters ended March 31, June 30 and September 30, 2008, and for the quarter and year ended December 31, 2008 (collectively, the "Earnings Releases"), should not be relied upon. The Company has restated the Previously Issued Financial Statements to correct these errors by amending its Quarterly Reports for the quarters ended March 31, June 30, and September 30, 2008. The Audit Committee has discussed this matter with the Company's independent registered accounting firm.

The errors in the Previously Issued Financial Statements relate to an incorrect payroll accrual for the quarters ended March 31, June 30, and September 30, 2008. As a result of this incorrect accrual, payroll expense and net loss were understated, and gross profit was overstated in the Previously Issued Financial Statements and Earnings Releases.

Table of Contents

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share data)			
2007				
Revenue	\$ 20,205	\$ 21,426	\$ 23,805	\$ 23,507
Gross profit	1,853	1,276	1,517	826
Net income (loss) attributable to common shareholders	(676)	(1,593)	153	(2,187)
Basic and diluted net income (loss) per share attributable to common shareholders	(0.19)	(0.45)	0.04	(0.59)
2006				
Revenue	\$ 17,373	\$ 17,704	\$ 19,984	\$ 20,664
Gross profit	1,999	1,806	1,809	1,864
Net loss attributable to common shareholders	(1,649)	(59)	(814)	(1,311)
Basic and diluted net loss per share attributable to common shareholders	(0.49)	(0.02)	(0.23)	(0.37)
Subsequent Events				

As part of our strategic review it was decided to sell our commercial subsidiary, Cornwall, in order to focus on the government business and to reduce our overall debt load. After reviewing a number of potential offers, we have signed a non-binding Letter of Intent to sell the business subject to the execution of definitive transaction documents and the satisfaction or waiver of customary conditions. Cornwall is based in Miami, Florida and provides physical security for clients in Miami, Fort Lauderdale, and West Palm Beach, Florida. It is estimated that the sale of Cornwall will permit us to reduce our senior debt by approximately \$8.0 million and save approximately \$2.0 million of interest expense on a full year basis. We expect to close during the second quarter of 2009.

Table of Contents**Tri-S Security Corporation****Schedule II Valuation and Qualifying Accounts**

Column A Description	Column B Balance at beginning of period	Column C Charged to costs and expenses	Additions Charged to other accounts describe	Column D Deductions describe	Column E Balance at end of period
Bad Debt Reserve (in thousands):					
Year ended December 31, 2008	\$ 701	\$ 777	\$	\$ 173(1)	\$ 1,305
Year ended December 31, 2007	\$ 797	\$ 488	\$	\$ 584(1)	\$ 701
Year ended December 31, 2006	\$ 1,181	\$ 59	\$	\$ 443(1)	\$ 797

(1) Write-offs.

F-29

Table of Contents

SIGNATURES

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

TRI-S SECURITY CORPORATION

By: /s/ RONALD G. FARRELL
Chairman of the Board and Chief Executive Officer

Date: April 14, 2009

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

Name	Title	Date
/s/ RONALD G. FARRELL Ronald G. Farrell	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	April 14, 2009
/s/ Nicolas V. Chater Nicolas V. Chater	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	April 14, 2009
/s/ MICHAEL F. BENNETT Michael F. Bennett	Director	April 14, 2009
/s/ JAMES M. LOGSDON James M. Logsdon	Director	April 14, 2009
/s/ L.K. TOOLE L.K. Toole	Director	April 14, 2009
/s/ JAMES A. VERBRUGGE James A. Verbrugge	Director	April 14, 2009

Table of Contents

Exhibit No.	Description	Method of Filing
1.1	Form of Underwriting Agreement entered into in connection with the Company's initial public offering.	Incorporated by reference to Exhibit 1.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
2.1	Stock Purchase Agreement dated February 23, 2004, among the Company and Charles Keathley, Robert Luther, Harold Bright and John Wilson. (The schedules to the Stock Purchase Agreement have been omitted from this Annual Report pursuant to Item 601(b)(2) of Regulation S-K, and the Company agrees to furnish copies of such omitted schedules supplementally to the Securities and Exchange Commission upon request.)	Incorporated by reference to Exhibit 2.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
2.2	Stock Purchase Agreement dated as of August 30, 2005, among the Company and the shareholders of The Cornwall Group, Inc. (The schedules to the Stock Purchase Agreement have been omitted from this Annual Report pursuant to Item 601(b)(2) of Regulation S-K, and the Company agrees to furnish copies of such omitted schedules supplementally to the Securities and Exchange Commission upon request.)	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on September 2, 2005.
2.3	Amendment No. 1 to Stock Purchase Agreement dated as of October 18, 2005, among the Company and the shareholders of The Cornwall Group, Inc.	Incorporated by reference to Exhibit 2.2 to the Company's Current Report on Form 8-K filed on October 24, 2005.
3.1	Amended and Restated Articles of Incorporation.	Incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
3.2	Amended and Restated Bylaws.	Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (No. 333-119737).
3.3	Articles of Amendment to Amended and Restated Articles of Incorporation of the Company, dated September 14, 2007.	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on September 19, 2007.
3.4	Amendment to the Amended and Restated Bylaws of the Company, adopted September 13, 2007.	Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on September 19, 2007.
3.5	Amendment to the Amended and Restated Bylaws of the Company, adopted December 13, 2007.	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on December 19, 2007.

Table of Contents

4.1	Form of Representative's Option for the Purchase of Warrants.	Incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.2	Form of Representative's Option for the Purchase of Common Stock.	Incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.3	Specimen Common Stock Certificate.	Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.4	Form of Warrant Agreement.	Incorporated by reference to Exhibit 4.4 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.5	Form of Warrant Issuable to Underwriters Upon Exercise of Option.	Incorporated by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.6	Specimen Warrant Certificate.	Incorporated by reference to Exhibit 4.6 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.7	Specimen Unit Certificate.	Incorporated by reference to Exhibit 4.7 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.8	Form of 10% Callable Convertible Promissory Note issued by the Company in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.9	Form of Warrant to purchase shares of the Company's common stock issued by the Company in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.10	Form of Registration Rights Agreement entered into by the Company and the investors signatory thereto in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.

Table of Contents

4.11	Form of 10% Callable Convertible Promissory Note issued by the Company in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.12	Form of Warrant to purchase shares of the Company's common stock issued by the Company in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.13	Form of Registration Rights Agreement entered into by the Company and the investors signatory thereto in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.6 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.14	Form of Warrant to purchase 150,000 shares of the Company's common stock issued to BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 2, 2006.
4.15	Form of Warrant to purchase 25,000 shares of the Company's common stock issued to LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on May 2, 2006.
4.16	Form of Warrant to purchase shares of the Company's common stock issuable to BRE LLC in respect of our advance under the Company's credit facility.	Incorporated by reference to Exhibit A to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2008.
4.17	Warrant to purchase 125,000 shares of the Company's common stock issued to BRE LLC on September 12, 2008.	Incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
4.18	Form of 14% Convertible Promissory Note issued in connection with the Company's exchange offer conducted November 13, 2008.	Incorporated by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
4.19	Form of Warrant issued in connection with the Company's exchange offer conducted November 13, 2008.	Incorporated by reference to Exhibit 4.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.

Table of Contents

4.20	Warrant to purchase 90,000 shares of the Company's common stock issued to BRE LLC on October 7, 2008.	Filed herewith.
4.21	Form of 14% Convertible Promissory Note issued to accredited investors on December 16, 2008.	Filed herewith.
4.22	Form of warrant to purchase 2,604 shares of the Company's common stock issued to accredited investors on December 16, 2008.	Filed herewith.
4.23	Warrant to purchase 90,000 shares of the Company's common stock issued to BRE LLC on January 7, 2009.	Filed herewith.
4.24	Form of 14% Convertible Promissory Note issued to accredited investors on January 8, 2009.	Filed herewith.
4.25	Form of warrant to purchase 3,906 shares of the Company's common stock issued to accredited investors on January 8, 2009.	Filed herewith.
4.26	Form of warrant to purchase 65,000 shares of the Company's common stock issued as compensation to a registered representative on January 9, 2009, in connection with the Company's exchange offer conducted on November 13, 2008.	Filed herewith.
4.27	Form of 14% Convertible Promissory Note issued to an accredited investor on February 3, 2009.	Filed herewith.
4.28	Form of warrant to purchase 5,208 shares of the Company's common stock issued to an accredited investor on February 3, 2009.	Filed herewith.
4.29	Form of 14% Convertible Promissory Note issued to an accredited investor on February 25, 2009.	Filed herewith.
4.30	Form of warrant to purchase 10,417 shares of the Company's common stock issued to an accredited investor on February 25, 2009.	Filed herewith.
10.1	Employment Agreement dated January 1, 2002, between the Company and Ronald G. Farrell. Represents an executive compensation plan or arrangement.	Incorporated by reference to Exhibit 10.24 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.2	Form of Exchange and Recapitalization Agreement among the Company and the holders of the Company's outstanding common stock, Series A Convertible Preferred Stock and Series B Convertible Preferred Stock.	Incorporated by reference to Exhibit 10.31 to the Company's Registration Statement on Form S-1 (No. 333-119737).

Table of Contents

10.3	Agreement dated May 5, 2003, among Paragon Systems, Inc. and International Union of Security, Police and Fire Professionals of America.	Incorporated by reference to Exhibit 10.37 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.4	Agreement dated December 16, 2003, among Paragon Systems Inc. and International Union, Security, Police, and Fire Professionals of America.	Incorporated by reference to Exhibit 10.38 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.5	Agreement dated March 1, 2002, between Paragon Systems, Inc. and International Technical and Professional Employees Union, AFL-CIO.	Incorporated by reference to Exhibit 10.39 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.6	Agreement dated December 1, 2003, between Paragon Systems, Inc. and United Union of Security Guards.	Incorporated by reference to Exhibit 10.40 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.7	Joint Venture Limited Liability Company Agreement for Army Fleet Support, LLC.	Incorporated by reference to Exhibit 10.41 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.8	Form of Indemnification Agreement.	Incorporated by reference to Exhibit 10.43 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.9	Paragon Systems, Inc. 401(k) Profit Sharing Plan, as amended.	Incorporated by reference to Exhibit 10.44 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.10	Amendment No. 1 to Employment Agreement between the Company and Ronald G. Farrell. Represents an executive compensation plan of agreement.	Incorporated by reference to Exhibit 10.64 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.11	Form of Consulting Agreement among the Company, Capital Growth Financial, LLC and Bathgate Capital Partners LLC.	Incorporated by reference to Exhibit 10.65 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.12	Promissory Note made by Ronald G. Farrell in favor of the Company dated December 31, 2004.	Incorporated by reference to Exhibit 10.66 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.13	Summary of Board Compensation	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.

Table of Contents

10.14	Factoring Agreement dated April 2005 between Paragon Systems, Inc. and LSQ Funding Group, L.L.C.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report Form 8-K filed on April 26, 2005.
10.15	Office Lease Agreement between the Company and V.V. Georgia, L.P. dated June 29, 2005.	Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
10.16	Letter Agreement dated August 10, 2005 between the Company and Ronald G. Farrell. Represents an executive compensation arrangement or plan.	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
10.17	Employment Agreement dated January 1, 2002, between the Company and Ronald G. Farrell. Represents an executive compensation arrangement or plan.	Incorporated by reference to Exhibit 10.24 to the Company's Registration Statement on Form S-1, as amended (No. 333-119737).
10.18	Employment Agreement between Paragon Systems, Inc. and Leslie Kaciban dated July 29, 2005.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on August 4, 2005.
10.19	Form of Qualified Stock Option Agreement.	Incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (No. 333-129097).
10.20	Form of Non-Qualified Stock Option Agreement.	Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (No. 333-129097).
10.21	Letter Agreement between the Company and E. Wayne Stallings dated August 12, 2005.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on August 18, 2005.
10.22	Earnest Money Escrow Agreement dated as of August 30, 2005, among the Company, The Cornwall Group, Inc., the Shareholder Representative and Berman Renert Vogl & Mandler, P.A.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on September 2, 2005.
10.23	Promissory Note dated October 18, 2005 in principal amount of \$250,000 made by the Company in favor of the Shareholder Representative.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on October 24, 2005.

Table of Contents

10.24	Credit Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.3 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.25	Factoring and Security Agreement dated as of October 18, 2005 among the Company, its subsidiaries and LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.4 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.26	Security Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.5 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.27	Pledge Agreement dated as of October 18, 2005 among the Company, LSQ Funding Group, L.C. and BRE LLC	Incorporated by reference to Exhibit 99.6 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.28	Guaranty Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.7 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.29	Employment Agreement between The Cornwall Group, Inc. and David H. Shopay dated October 18, 2005.	Incorporated by reference to Exhibit 99.8 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.30	Escrow Agreement dated as of October 18, 2005 among the Company, SunTrust Bank and the Shareholder Representative.	Incorporated by reference to Exhibit 99.9 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.31	Amendment to Credit Agreement, dated as of December 30, 2005, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 6, 2006.
10.32	Amendment to Pledge Agreement, dated as of October 19, 2005, but executed on December 30, 2005, among the Company, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on January 6, 2006.
10.33	Agreement between International Monitoring, Inc. and Devcon Security Services Corporation dated March 2, 2006.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on March 8, 2006.

Table of Contents

10.34	Amendment and Forbearance Agreement dated as of March 29, 2006 by and among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on April 4, 2006.
10.35	Agreement to sell certain real property located in Fort Lauderdale, Florida.	Incorporated by reference to Exhibit 10.92 on the Company's Annual Report on Form 10-K for the year ended December 31, 2005.
10.36	Letter Agreement dated April 10, 2006, between International Monitoring, Inc. and Devcon Security Services Corporation.	Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.
10.37	Joint Venture Agreement dated January 17, 2006, between Paragon Systems, Inc. and Southeastern Protective Services, Inc.	Incorporated by reference to Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.
10.38	Purchase Agreement dated as of May 19, 2006, among the Company, Paragon Systems, Inc. and L-3 Communications Integrated Systems, LP.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 23, 2006.
10.39	Summary of Board Compensation.	Incorporated by reference to Exhibit 10.6 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.
10.40	Guaranty of Joint Venture Executed by Paragon Systems, Inc. on June 27, 2006.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on June 30, 2006.
10.41	Waiver, Consent and Amendment among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC dated as of June 27, 2007.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on June 30, 2006.
10.42	Amendment to Employment Agreement between the Company and Ronald G. Farrell dated January 10, 2007.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 11, 2007.
10.43	Settlement Agreement and General Release dated January 26, 2007, between the Company and David Shopay, on behalf of himself and the other former shareholders of The Cornwall Group, Inc.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on February 1, 2007.

Table of Contents

10.44	Copy of the selected portions of the Investor Fact Sheet released on or about January 24, 2007.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on February 7, 2007.
10.45	Amendment and Forbearance dated as of March 23, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 10.79 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.46	Acknowledgment of Forbearance and Reaffirmation of Guaranty dated as of March 23, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 10.80 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.47	Pledge Agreement dated as of March 23, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 10.81 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.48	Mediation Settlement Agreement dated as of May 18, 2007, among the Company, Paragon Systems, Inc., Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 24, 2007.
10.49	Employment Agreement, dated September 14, 2007, between the Company and John R. Oliver.	Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007.
10.50	Settlement Agreement and General Release dated September 13, 2007, among the Company, Paragon Systems Inc., Ronald G. Farrell, Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on September 19, 2007.
10.51	Voting Agreement, dated September 13, 2007, among the Company, Ronald G. Farrell, Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on February 7, 2007.
10.52	Amended and Restated Credit Agreement, dated as of December 31, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 7, 2008.
10.53	Loan and Security Agreement, dated as of December 31, 2007, among the Company, its subsidiaries and LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on January 7, 2008.

Table of Contents

10.54	Supplemental Agreement to Amended and Restated Credit Agreement, dated as of December 31, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.3 to the Company's Current Report on Form 8-K filed on January 7, 2008.
10.55	Employment Agreement, dated November 19, 2007, between the Company and Nicholas V. Chater. Represents an executive compensation plan or arrangement.	Incorporated by reference to Exhibit 10.82 on the Company's Annual Report on Form 10-K for the year ended December 31, 2007.
10.56	Amendment and Forbearance, dated as of March 26, 2008, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 10.83 on the Company's Annual Report on Form 10-K for the year ended December 31, 2007.
10.57	Amended and Restated Supplemental Agreement and Amended and Restated Credit Agreement, among LSQ Funding Group, L.C., BRE LLC and the Company and its subsidiaries, dated July 30, 2008 and effective as of May 1, 2008.	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2008.
10.58	Amendment to Amended and Restated Supplemental Agreement and Amendment to Amended and Restated Credit Agreement among LSQ Funding Group, L.C., BRE LLC, and the Company and its subsidiaries, dated September 12, 2008.	Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
10.59	Director Designation Agreement between Select Contrarian Value Partners, L.P. and the Company, dated October 16, 2008.	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
10.60	Amendment No. 1 to Director Designation Agreement between Select Contrarian Value Partners, L.P. and the Company, dated November 5, 2008.	Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
10.61	Letter Agreement between Select Contrarian Value Partners, L.P. and the Company, dated November 5, 2008.	Incorporated by reference to Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
10.62	Amendment and Forbearance, dated as of December 12, 2008, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Filed herewith.

Table of Contents

10.63	Amended and Restated 2004 Stock Incentive Plan, as amended as of December 19, 2008.	Filed herewith.
10.64	Amendment to Employment Agreement between the Company and Ronald G. Farrell, dated December 31, 2008. Represents an executive compensation plan or arrangement.	Filed herewith.
10.65	Joint Stipulation of Settlement and Release between Hal Unschuld, individually and on behalf of the class he seeks to represent, the Company, Ronald Farrell, E. Wayne Stallings, Capital Growth Financial, LLC and Bathgate Capital Partners, LLC, filed March 9, 2009 (subject to approval by the State Court of Fulton County, State of Georgia).	Filed herewith.
21.1	Subsidiaries of the Company.	Filed herewith.
23.1	Consent of Habif, Arogeti & Wynne, LLP.	Filed herewith.
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Executive Officer.	Filed herewith.
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Financial Officer.	Filed herewith.
32.1	Section 1350 Certification of the Company's Chief Executive Officer.	Filed herewith.
32.2	Section 1350 Certification of the Company's Chief Financial Officer.	Filed herewith.