

ARGYLE SECURITY, INC.

Form 10-Q/A

May 19, 2009

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q/A  
Amendment No. 1**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2009.**

**or**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number: 000-51639**

**Argyle Security, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

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

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

**12903 Delivery Drive  
San Antonio, TX 78247**

(Address of Principal Executive Offices including Zip Code)

**(210) 495-5245**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

There were 6,267,105, shares of the Registrant's common stock issued and outstanding as of May 15, 2009.

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**EXPLANATORY NOTE**

We are filing this Amendment No. 1 to our Quarterly Report on Form 10-Q/A (the Amended Report ) solely to correct certain typographical errors relating to the description of the maturity date of the subordinated loan contained in (i) footnote no. 5 to the financial statements contained in Item 1 on page 18 and (ii) the subsection entitled Unsecured Debt Related Parties in the Liquidity and Capital Resources Section of Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Item 2 on page 43 of our Quarterly Report on Form 10-Q, filed on May 15, 2009 (the Original Report ).

The correct statement is as follows:

***Unsecured Debt Related Parties***

On January 2, 2008 an additional \$5.0 million in unsecured debt was funded to ISI by the same related party for which \$6.0 million was outstanding at December 31, 2007. All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreements contain prepayment options with prepayment penalties. Interest on the additional \$5.0 million of debt accrues at 11.58% per annum and is payable quarterly in arrears, deferred interest at the rate of 8.42% per annum, and default interest of an additional 2.0% per annum. The interest rate on all outstanding notes will increase by 4.0% if the outstanding notes are not repaid by September 30, 2010. The total debt of \$11.0 million plus accrued and unpaid interest is due and payable in one single payment on January 31, 2011. Argyle has agreed to guarantee the payment of the outstanding unsecured debt. There are both financial and restrictive covenants associated with the note agreements. As of March 31, 2009, ISI was in compliance or had received a waiver of non-compliance with all covenants. ISI expects to be in compliance with the modified covenants for the next year. On September 30, 2008, Argyle provided an unsecured, subordinated loan of \$2.0 million to ISI. The term of the loan was one month with the payment of all outstanding principal and accrued and unpaid interest due on October 31, 2008. The rate of interest was 6.0% per annum. The loan was repaid in full on October 3, 2008.

On October 28, 2008, the Board approved Argyle s providing guarantees to ISI and its subsidiaries as an alternative to bonding, in an aggregate amount of up to \$15.0 million, in order to allow us the ability to bid projects without obtaining bonding.

We believe that the corrections described above and certain conforming changes made in the Amended Report, are not, individually or in the aggregate, material to our business, financial condition or results of operations.

In addition, pursuant to the rules of the SEC, Item 6 of Part II of the Original Report has been amended to contain currently dated certifications from our Chief Executive Officer, President and Chief Operating Officer, Executive Vice President and Chief Financial Officer and Vice President and Corporate Controller as required by Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended, which certifications are filed herewith as Exhibits 31.1, 31.2, 31.3 and 31.4, respectively.

This Amended Report only amends the Original Report to the extent described above, and no other information in the Original Report is amended hereby. None of the items amended herein nor any other item in the Original Report has been updated to reflect events, results or developments concerning our business, financial condition or results of operations occurring after the date of the Original Report or to modify or update those disclosures affected by subsequent events. Except for the foregoing amended items, this Amended Report continues to describe conditions as of the date of the Original Report. Among other things, and without limiting the foregoing, forward looking statements made in the Original Report have not been revised to reflect events, results or developments that occurred or facts that became known to us after the date of the Original Report, and such forward looking statements should be read in their historical context.

**Argyle Security, Inc. Index to Form 10-Q**

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**PART I FINANCIAL INFORMATION**  
**ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**ARGYLE SECURITY, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands except share data)

	<b>March 31, 2009 unaudited</b>	<b>December 31, 2008</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 9,367	\$ 11,142
Restricted cash	5,000	2,500
Receivables:		
Contract net of allowance for doubtful accounts of \$787 and \$777 at March 31, 2009 December 31, 2008, respectively	27,959	28,815
Contract receivables related party	3,791	4,685
Other receivables	7	335
Costs and estimated earnings in excess of billings on incomplete contracts	8,181	6,475
Intangible assets	74	184
Refundable income taxes	192	168
Inventory	1,595	2,146
Other current assets	15	6
Prepays	295	379
Deferred income taxes, net	375	898
<b>Total current assets</b>	<b>56,851</b>	<b>57,733</b>
Property and equipment, net	8,856	9,033
Goodwill	2,844	2,844
Intangible assets	11,770	12,111
Deposits, deferred transaction costs, and other assets	457	591
<b>Total other assets</b>	<b>23,927</b>	<b>24,579</b>
<b>Total assets</b>	<b>\$ 80,778</b>	<b>\$ 82,312</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 15,187	\$ 15,799
Accounts payable related party	90	173
Billings in excess of costs and estimated earnings on incomplete contracts	9,055	7,633
Interest payable to stockholders		49
Current portion of capitalized lease obligations	244	239
Current portion of long-term debt	3,807	3,235
Deferred income taxes		

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Total current liabilities	28,383	27,128
Long-Term Liabilities:		
Deferred income taxes	1,217	1,577
Long-term debt less current portion	22,611	29,558
Derivative, deferred rent and other long term liabilities (including dividends)	831	635
Long-term capitalized lease obligations less current portion	3,326	3,389
Total long-term liabilities	27,985	35,159
Total liabilities	56,368	62,287
Stockholders Equity		
Preferred stock of Argyle Security, Inc. \$.0001 par value; 1,000,000 shares authorized; 18,750 shares of Series A and 27,273 shares of Series B at March 31, 2009 and 18,750 shares of Series A at December 31, 2008 issued and outstanding		
Common stock of Argyle Security, Inc. \$.0001 par value; 89,000,000 shares authorized; shares issued and outstanding 6,267,105 shares at March 31, 2009 and 5,969,342 shares at December 31, 2008		
	1	1
Additional paid in capital	55,685	50,925
Accumulated other comprehensive income (loss)	(117)	(116)
Accumulated earnings (deficit)	(31,159)	(30,785)
Total stockholders equity	24,410	20,025
Total liabilities and stockholders equity	\$ 80,778	\$ 82,312

See notes to unaudited consolidated financial statements

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**ARGYLE SECURITY, INC.**  
**CONSOLIDATED STATEMENT OF OPERATIONS**  
**(unaudited)**

(in thousands except share data)

	<b>Three Months Ended</b>	
	<b>March 31, 2009</b>	<b>March 31, 2008</b>
Revenues:		
Contract revenues	\$ 25,326	\$ 26,860
Contract revenues related party	860	6,943
Manufacturing revenues	1,901	1,518
Service and other revenues	3,657	2,276
<b>Total revenues</b>	<b>31,744</b>	<b>37,597</b>
Cost of revenues:		
Contract costs	21,332	27,342
Manufacturing costs	1,258	690
Service and other costs, include \$110 and \$1,252 of amortization of intangibles in 2009 and 2008 , respectively	2,497	3,161
<b>Total cost of revenues</b>	<b>25,087</b>	<b>31,193</b>
<b>Gross profit</b>	<b>6,657</b>	<b>6,404</b>
Operating expenses:		
Salaries and related expense, including stock-based compensation of \$145 and \$558 in 2009 and 2008, respectively	3,010	3,369
Professional fees and outside services	880	945
General and administrative expenses	1,226	1,588
Depreciation	425	459
Amortization of intangible assets	341	421
<b>Total operating expenses</b>	<b>5,882</b>	<b>6,782</b>
<b>Operating income (loss)</b>	<b>775</b>	<b>(378)</b>
Other income (expense):		
Interest income	25	26
Interest expense	(883)	(799)
<b>Total other income (expense)</b>	<b>(858)</b>	<b>(773)</b>
<b>Income (loss) before provision for income taxes</b>	<b>(83)</b>	<b>(1,151)</b>
(Benefit) Provision for income taxes	148	(417)
<b>Net income (loss)</b>	<b>(231)</b>	<b>(734)</b>
Dividends on redeemable preferred stock	(143)	
<b>Net income (loss) allocable to holders of non-redeemable common stock</b>	<b>\$ (374)</b>	<b>\$ (734)</b>

Weighted-average number of shares of common stock outstanding exclusive of shares subject to possible redemption:

Basic	6,019,495	5,749,342
Diluted	6,019,495	5,749,342

Net income (loss) per share allocable to holders of non-redeemable common stock:

Basic	\$ (0.06)	\$ (0.13)
Diluted	\$ (0.06)	\$ (0.13)

See notes to unaudited consolidated financial statements



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**ARGYLE SECURITY, INC.**  
**CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY**  
**DECEMBER 31, 2008 THROUGH MARCH 31, 2009**  
**(unaudited)**  
(in thousands except share data)

	Common Stock		Preferred Stock		Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Earnings / (Deficit)	Total Stockholders Equity
	Shares	Amount	Shares	Amount				
<b>Balance at December 31, 2008</b>	<b>5,969,342</b>	<b>\$ 1</b>	<b>18,750</b>	<b>\$ 0</b>	<b>\$ 50,925</b>	<b>\$ (116)</b>	<b>\$ (30,785)</b>	<b>\$ 20,025</b>
Net income (loss)							(231)	(231)
Deferred loss on hedging activities, net of taxes						(1)		(1)
ISI seller note conversion	192,763				1,928			1,928
Stock-based compensation	135,000				145			145
Forfeiture of stock-based compensation	(30,000)							
Issuance of preferred stock			27,273	0	2,687			2,687
Dividends on preferred stock							(143)	(143)
Common stock registration costs								
<b>Balance at March 31, 2009</b>	<b>6,267,105</b>	<b>\$ 1</b>	<b>46,023</b>	<b>\$ 0</b>	<b>\$ 55,685</b>	<b>\$ (117)</b>	<b>\$ (31,159)</b>	<b>\$ 24,410</b>

See notes to unaudited consolidated financial statements

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**ARGYLE SECURITY, INC.**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
**(unaudited)**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31,</b>
	<b>2009</b>	<b>2008</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (231)	\$ (734)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities		
Stock-based compensation	145	558
Amortization	451	1,673
Depreciation	464	488
Gain (loss) on disposal of asset	3	
Deferred interest on Merit debt	115	
Decrease (increase) in contract receivables	856	(15,552)
Decrease (increase) in related party contract receivables	894	684
Decrease (increase) in other receivables	328	(6)
Decrease (increase) in costs and estimated earnings in excess of billings	(1,706)	2,702
Decrease (increase) in other assets	583	237
Increase (decrease) in accounts payable and accrued expenses	(466)	3,569
Increase (decrease) in other long-term liabilities	47	18
Increase (decrease) in deferred income taxes and refundable taxes	139	(392)
Increase (decrease) in billings in excess of costs and estimated earnings	1,422	3,854
<b>Net cash provided by (used in) operating activities</b>	<b>\$ 3,044</b>	<b>\$ (2,901)</b>
<b>Cash flows from investing activities:</b>		
Acquisition of PDI, Com-Tec, and Fire Quest in 2008, net of cash acquired		(5,259)
Purchase of property and equipment	(291)	(781)
Transaction costs		(223)
<b>Net cash provided by (used in) investing activities</b>	<b>\$ (291)</b>	<b>\$ (6,263)</b>
<b>Cash flows from financing activities:</b>		
Issuance of preferred stock	3,000	
Restricted cash	(2,500)	
Offering costs and financing costs	(406)	(7)
Repayment on borrowings	(10,884)	(12,071)
Proceeds from borrowings	6,320	15,136
Proceeds from notes payable		5,105
Payments on capital lease obligations	(58)	(23)
<b>Net cash provided by (used in) financing activities</b>	<b>\$ (4,528)</b>	<b>\$ 8,140</b>

<b>Net increase (decrease) in cash and cash equivalents</b>	<b>\$ (1,775)</b>	<b>\$ (1,024)</b>
Cash and cash equivalents at beginning of year	<b>11,142</b>	<b>3,556</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 9,367</b>	<b>\$ 2,532</b>

See notes to unaudited consolidated financial statements

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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

**Note 1 Basis of Presentation**

Argyle Security, Inc. (formerly Argyle Security Acquisition Corporation) ( Argyle ) was incorporated in Delaware in June 2005 as a blank check company formed to acquire, through merger, capital stock exchange, asset acquisition, or other similar business combination, a business in the security industry. Argyle completed its initial public offering in January 2006. On July 31, 2007, Argyle consummated its initial acquisition through the acquisition of 100.0% of the outstanding capital stock of ISI Security Group, Inc. (f/k/a ISI Detention Contracting Group, Inc., referred to herein as ISI ) and its subsidiaries. When used herein, Argyle , the Company , we , us , our , refers to the pre-acquisition company until July 31, 2007 and the post-acquisition company after July 31, 2007.

The consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission that permit reduced disclosure for interim periods. We believe that these consolidated financial statements include all adjustments (consisting only of normal recurring accruals) necessary to present fairly the results for the interim periods shown. The results for the interim periods are not necessarily indicative of results for the full year. You should read this document in conjunction with the consolidated financial statements and accompanying notes included in our Form 10-K for the year ended December 31, 2008.

Argyle is a comprehensive security solutions provider to our diverse customer base because it addresses the majority of their physical electronic security requirements. Argyle is a detention and commercial equipment contractor that specializes in designing and integrating security solutions, including turnkey installations, design, engineering, supply, and installation of various detention, surveillance and access control equipment and software solutions for correctional facilities and commercial institutions. The work is performed under fixed-price contracts. The projects are located in various cities throughout the United States. The length of the contracts varies but is typically less than two years. Argyle also provides turnkey installations covering the full spectrum of electronic security and low voltage systems, including fire alarm, access control, closed circuit television, intercom, sound/paging and other custom designed systems.

In February 2008, we organized our business under the name of Argyle Security USA and then, in January 2009, we eliminated the name Argyle Security USA and, for the sole purpose of debt covenant compliance calculation which only considers the operating business financial condition, organized the operational business of Argyle under the name Argyle Security Operations , or ASO , through which we provide security solutions to commercial, governmental and correctional customers. Argyle has two reporting segments or business divisions: Argyle Corrections and Argyle Commercial Security .

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

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

On January 31, 2008, ISI Controls, Ltd. ( ISI-Controls ), a wholly owned subsidiary of ISI, which in turn is a wholly owned subsidiary of the Company, closed a transaction, pursuant to which ISI-Controls acquired 100.0% of the outstanding units of Com-Tec, resulting in Com-Tec becoming a wholly owned subsidiary of ISI-Controls. Com-Tec is engaged in the business of custom design, manufacture and installation of electronic security and communications systems.

The unaudited consolidated financial statements of Argyle, as of March 31, 2009 and 2008, include the accounts of the Company and all wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included.



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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

**Note 1 Basis of Presentation (continued)*****Pro Forma Results of Operations***

Because we acquired ISI in July 2007, and Fire Quest, PDI and Com-Tec in January 2008, we previously presented a Management's Discussion and Analysis of Financial Condition in our Annual and Quarterly Reports which included the pro forma results of operations for the Company and the acquisitions as if the acquisitions occurred on January 1, 2008 and January 1, 2007, respectively. We have concluded that because, other than Com-Tec which acquisition was effective on January 31, 2008, all acquired companies were included in the three month period ended March 31, 2008 that the pro forma presentation is no longer beneficial to our stockholders and such presentation has not been included in the Management's Discussion and Analysis of Financial Condition section of this report. The results of operations of Com-Tec for the one month ended January 31, 2008 are not reflected in the consolidated financial statements for the Company for the three months ended March 31, 2008.

The Pro Forma results of operations for the Company for the three months ended March 31, 2009 and 2008 are as if the acquisition of Com-Tec occurred on January 1, 2008. We derived the pro forma results of operations from (i) the unaudited consolidated financial statements of the Company for the three months ended March 31, 2009 and 2008 and (ii) the unaudited consolidated financial statements of Com-Tec for the one month ended January 31, 2008. There was no difference between the GAAP and the pro forma statement of operations from the three months ended March 31, 2009 and only minor differences (revenues of \$1.7 million or 4.6% and \$14,000 in net income (loss) or 1.9%) between GAAP and the proforma statement of operations for the same period in 2008.

**Pro Forma Consolidated Statement of Operations Data**  
**(unaudited)**

(in thousands except share data)

	<b>Three Months Ended</b>	
	<b>March 31, 2009</b>	<b>March 31, 2008</b>
Total revenues	31,744	39,315
Net income (loss) allocable to holders of non-redeemable common stock	\$ (374)	\$ (748)
Weighted-average number of shares of common stock outstanding exclusive of shares subject to possible redemption:		
Basic	6,019,495	5,749,342
Diluted	6,019,495	5,749,342
Net income (loss) per share allocable to holders of non-redeemable common stock:		
Basic	\$ (0.06)	\$ (0.13)
Diluted	\$ (0.06)	\$ (0.13)



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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

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

***Cash and Cash Equivalents***

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

***Restricted Cash***

Represents bank and certificates of deposit required by the Company's commercial bank letter of credit.

***Contract Receivables***

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

The amount recognized for bad debt expense for the three months ended March 31, 2009 and 2008 was \$50,000 and \$145,000, respectively, and is reflected in the general and administrative expenses of the Statement of Operations.

***Revenue Recognition***

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

***Construction Contracts***

Construction Contracts are those as defined in the American Institute of Certified Public Accountants' Statement of Position 81-1 (SOP 81-1), *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Most of the Company's contracts extend over a period of 6 to 14 months (6 to 9 months for Argyle Commercial Security and 9 to 14 months for Argyle Corrections), which is the period the Company considers to be its operating cycle. Such contracts generally provide that the customers accept completion of progress to date and compensate the Company for services rendered measured in terms of units installed, hours expended or some other measure of progress. Revenues from Construction Contracts are recognized on the percentage-of-completion method in accordance with SOP 81-1. The Company recognizes revenues on signed letters of intent, contracts and change orders. Percentage-of-completion for Construction Contracts is measured principally by the percentage of costs incurred and accrued to date for each contract to the estimated total costs for each contract at completion. The Company generally considers contracts to be substantially complete upon departure from the work site and acceptance by the customer. Contract costs include all direct material, labor, subcontract, equipment costs, related payroll taxes and insurance costs, and any other indirect costs related to contract performance. Changes in job performance, job conditions, estimated contract costs, profitability and final contract settlements may result in revisions to costs and income, and the effects of these revisions are recognized in the period in which the revisions are determined. Provisions for total estimated losses on incomplete contracts are made in the period in which such losses are determined.

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

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



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

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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

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

***Service Sales***

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

***Shipped Products***

Revenues are recognized by PDI when the product is shipped to the customer in accordance with the contractual shipping terms. In almost all cases the shipping of products to PDI's customers is FOB Origin, whereby title passes to the purchaser when the product leaves the PDI premises under the bail of a common carrier. In only rare instances (less than 2.0% of all shipments) are products shipped to PDI customers as FOB Destination, whereby title passes to the purchaser when the product reaches its destination. When delivery to the customer's delivery site has occurred, the customer takes title and assumes the risks and rewards of ownership.

The Company incurred \$142,000 in shipping and handling costs which are reflected in the service and other costs in the Statement of Operations.

***Inventory***

Inventory is valued at the lower of cost or market and consists of raw materials, work in process (WIP) and finished goods in the three months ended March 31, 2009 and December 31, 2008. Costs of inventory are determined using the average cost method for all of the business units. The \$1.0 million of inventory that was acquired from the Fire Quest, Com-Tec and PDI acquisitions has been stated at fair value at the date of acquisition during the first quarter of fiscal year 2008. The Company performs quarterly review of its inventory holdings to determine appropriate reserves for obsolescence. At March 31, 2009 and December 31, 2008, the Company's inventory balance (net of reserves) was \$1.6 million and \$2.1 million, respectively.

***Property and Equipment***

The \$1.2 million of property and equipment from the Fire Quest, Com-Tec, and PDI acquisitions have been stated at fair value at the date of acquisition in the first quarter of fiscal year 2008. Depreciation is calculated on the straight-line method.

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

***Assets Held Under Capital Leases***

Assets held under capital leases are classified under property and equipment on the Company's balance sheet and are recorded at the lower of the net present value of the minimum lease payments or the fair value of the asset at the inception of the lease. Amortization expense is computed using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

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

***Goodwill and Other Intangible Assets***

Goodwill represents the excess of the purchase price over the fair value of net assets acquired, including the amount assigned to identifiable intangible assets. Goodwill is reviewed for impairment annually, or more frequently if impairment indicators arise. Our annual impairment review requires extensive use of accounting judgment and financial estimates. The analysis of potential impairment of goodwill requires a two-step process. The first step is to identify if a potential impairment exists by comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to have a potential impairment, and the second step of the impairment test is not necessary. However, if the carrying amount of a reporting unit exceeds its fair value, the second step is performed to determine if goodwill is impaired and to measure the amount of impairment loss to recognize, if any.

The second step compares the implied fair-value of goodwill with the carrying amount of goodwill. If the implied fair value of goodwill exceeds the carrying amount, then goodwill is not considered impaired. However, if the carrying amount of goodwill exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess.

The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination (i.e., the fair value of the reporting unit is allocated to all the assets and liabilities, including any unrecognized intangible assets, as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit were the purchase price paid to acquire the reporting unit).

We have elected to make the first day of the third quarter the annual impairment assessment date for goodwill and other intangible assets. However, we could be required to evaluate the recoverability of goodwill and other intangible assets prior to the required annual assessment if we experience disruptions to the business, unexpected significant declines in operating results, divestiture of a significant component of the business or a sustained decline in market capitalization.

The Company identified its reporting units under the guidance of SFAS 142 *Goodwill and Other Intangible Assets* (FAS 142) and EITF Topic D-101, *Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142*. The Company's reporting units are ISI-Detention, MCS-Detention, PDI, Com-Tec (which comprise the Argyle Corrections segment), and MCS-Commercial which comprises the Argyle Commercial segment.

***Software Costs***

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

***Self Insurance***

ISI, PDI and Com-Tec are self-insured to certain limits under their respective group health and dental plans. On a quarterly basis, the Company estimates its health insurance cost, for its self-insured employee base at ISI, based upon expected health insurance claims for the current year. The insurance company which provides both the stop loss and total aggregate insurance coverages also provides the average, or expected, and maximum, claims for each class. The average and maximum claims are based on the Company's demographics and prior claim history. The Company uses the average claims history for the trailing 12 months as its basis for accruing health care cost.

***Warranty Reserve***

The Company warrants its products against defects in design, materials and workmanship generally for periods ranging from one to two years. A provision for estimated future costs related to warranty expense is recorded when products are sold. Management estimates the provision based primarily on historical warranty claim experience. As of

March 31, 2009, the warranty reserve was \$204,000 and is included in accounts payable and accrued expenses on the audited consolidated balance sheet.

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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
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**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

***Fair Value of Financial Instruments***

The fair value hierarchy in SFAS 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, giving the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs. Level 1 inputs to a fair value measurement are quoted market prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

The recorded fair value of financial instruments (Level 2), includes the interest rate swap which is discussed in more detail in Note 5. The carrying value of the revolving line of credit (Level 2) which is discussed in more detail in Note 5 approximates fair value due to its variable interest rate. The recorded value of the long-term debt (Level 2) which is discussed in more detail in Note 5 approximates fair value based on borrowing rates currently available to the Company for financing arrangements with similar terms and average maturities.

***Income Taxes***

The Company accounts for income taxes under the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded based on enacted statutory rates to reflect the tax consequences in future years of the differences between the tax bases of assets and liabilities and their financial reporting amounts. Deferred tax assets which will generate future tax benefits are recognized to the extent that realization of such benefits through future taxable earnings or alternative tax strategies in the foreseeable short-term future is more likely than not. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

The Company adopted 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 clarifies the accounting for uncertainty in income taxes recognized in financial statements and requires the impact of a tax position to be recognized in the financial statements if that position is more likely than not of being sustained by the taxing authority. The adoption of FIN 48 did not have an effect on our consolidated financial position or results of operations. The Company has applied the accounting provisions of FIN 48 to its tax positions and determined that no uncertain tax positions presently exist. The Company would record any interest and penalties related to unrecognized tax benefits in income tax expense.

***Sales and Use Taxes***

The Company collects and remits taxes on behalf of various state and local tax authorities. For the three months ended March 31, 2009, the Company collected \$334,000 and remitted \$420,000 in taxes. Sales and use taxes are reflected in the general and administrative expenses on a net basis.

***Reclassifications***

Prior-year balances have been reclassified to conform to current-year presentation. The statement of operations includes a reclassification of manufacturing revenues and manufacturing cost of revenues that were service and other revenues and service and other cost of revenues.

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

***Recently Issued Accounting Pronouncements***

In April 2009, the FASB released FSP FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* (FSP FAS 107-1). FSP FAS 107-1 extends the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (Statement 107), to interim financial statements of publicly traded companies as defined in APB Opinion No. 28, *Interim Financial Reporting*. FSP FAS 107-1 is effective for interim reporting periods ending after 15 June 2009, with early adoption permitted for periods ending after 15 March 2009. Early adoption of this FSP is permitted only if the entity also elects to early adopt FSP FAS 157-4 and FSP FAS 115-2.

***Recently Adopted Accounting Pronouncements***

In April 2009, the FASB issued FASB Staff Position FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (FSP FAS 141(R)-1). The FSP amends FASB Statement No. 141 (revised 2007), *Business Combinations* (Statement 141(R)), to require that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value, in accordance with FASB Statement No. 157, *Fair Value Measurements*, if the fair value can be determined during the measurement period. The FASB believes that fair value can be determined for many warranty obligations, which are subject to the guidance in this FSP. This FSP is effective immediately for us, and its impact will vary with each acquisition.

In May 2008, the FASB issued FASB Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1). FSP APB 14-1 specifies that issuers of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The amount allocated to the equity component represents a discount to the debt, which is amortized into interest expense using the effective interest method over the life of the debt. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is not permitted. We adopted the provisions of FSP APB 14-1 on January 1, 2009, and the adoption had no impact on our consolidated financial statements since none of our current convertible instruments are within the scope of this FSP given they can only be converted into common stock.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines Fair Value, establishes a framework for measuring Fair Value and expands disclosures about Fair Value measurements, but does not change existing guidance as to whether or not an instrument is carried at Fair Value. In February 2008, the FASB released a FASB Staff Position, FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, ( FSP FAS 157-2 ), which delayed the effective date of SFAS No. 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the condensed consolidated financial statements on a recurring basis. The Company adopted SFAS No. 157 as of January 1, 2008, which, among other things, requires enhanced disclosures about financial assets and liabilities that are measured and reported at fair value. SFAS No. 157 establishes a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the entity (observable inputs) and the entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). In accordance with FSP FAS 157-2, the Company elected to defer application of SFAS No. 157 to nonfinancial assets and liabilities that are not recognized or disclosed at fair value in the consolidated financial statements on a recurring basis until January 1, 2009. The adoption of SFAS No. 157 for nonfinancial assets and liabilities on January 1, 2009 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows.



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

The fair value hierarchy in SFAS 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, giving the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs. Level 1 inputs to a fair value measurement are quoted market prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

The Company measures its derivative financial instruments at fair value on a recurring basis. As of March 31, 2009, the Company had in place an interest rate swap agreement, which was entered into on December 1, 2008, to partially hedge the Company's variable rate debt.

The Company has options to convert or extend the PDI Promissory Notes which resulted in the creation of compound embedded derivatives for which the Company has performed valuations on a regular basis. The Company currently and will continue to mark to market these derivatives for which any changes in fair value are recognized in the statement of operations, in all the subsequent quarters until they are exercised or have expired.

In March 2008, the FASB issued SFAS No. 161 *Disclosures about Derivative Instruments and Hedging Activities an Amendment of FASB Statement No. 133*. The new standard requires additional disclosures regarding a company's derivative instruments and hedging activities by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires disclosure of derivative features that are credit risk-related as well as cross-referencing within the notes to the financial statements to enable financial statement users to locate important information about derivative instruments, financial performance and cash flows. The standard is effective for our fiscal year and interim periods beginning January 1, 2009, with early application encouraged.

On January 1, 2009, we adopted FASB Staff Position No. EITF 03-6-1 ( FSP EITF 03-6-1 ), *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. FSP EITF 03-6-1 states that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The adoption of FSP EITF 03-6-1 did not have a material impact on our results of operations or financial position.



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**ARGYLE SECURITY, INC.**  
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**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)**

***Use of Estimates***

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

Although estimating is a continuous and normal process for companies in the construction industry, material revisions in estimates of the percentage of completion require disclosure under FASB Statement No. 154, *Accounting Changes and Error Corrections* ( SFAS No 154 ). The effect on income from continuing operations, net income and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects future periods. Additionally, the Statement requires that, if a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

During the three months ended March 31, 2009, the Company conducted regular reviews and evaluations for the cost estimates associated with all of the approximately 1,300 active construction contracts in the Company's Work-in-Process. Changes in cost estimates come as the result of customer-ordered change orders, changes in material or labor costs and issues associated with managing the projects. As a result of the review the cost estimates for the in-process construction contracts (that existed as of quarter ended March 31, 2009) increased by a net \$1.7 million in quarter ended March 31, 2009. Of the aforementioned net estimated cost increases of \$1.7 million, 11 contracts had cost estimate changes of approximately \$100,000 or greater resulting in \$1.6 million. Eight of the total 11 of the contracts with changes greater than \$100,000 resulted in cost estimate increases totaling \$2.0 million while three contracts had estimated cost decreases totaling \$400,000. Approximately 1,260 of the remaining contracts with variances of less than \$100,000 resulted in a net decrease in cost estimates of \$2,000.

***Contingencies***

Certain conditions may exist as of the date of the consolidated balance sheet, which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company's management and its legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Company or its subsidiaries or unasserted claims that may result in such proceedings, the Company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims, as well as the perceived merits of the amount of relief sought or expected to be sought therein.

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

Loss contingencies that are considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed. As of March 31, 2009, the Company did not have any loss contingencies requiring disclosures or accruals.

***Concentrations of Credit Risk***

Financial instruments that potentially expose the Company to concentrations of credit risk, as defined by SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, consist primarily of contract receivables. During the quarter ended March 31, 2009, Revenues from our top three customers (all from Argyle Corrections) represented 29.4% of total Company revenues, respectively. During the quarter ended March 31, 2009, the Company had revenues from our top two customers (all from Argyle Corrections), which represented 23.3% of total Company revenues. These

concentrations are up from the year ended December 31, 2008 and 2007, when the top three customers represented 27.0% and 20.0% of total Company revenues, respectively. See Related-Party Transactions footnote (see Note 13) for discussion of transactions with ISI\*MCS, Ltd.

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**ARGYLE SECURITY, INC.**  
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**Note 2 Background, Formation, and Summary of Significant Accounting Policies (continued)****Net Income / (Loss) Per Share**

Net income/(loss) per share (basic) is calculated in accordance with the provisions of SFAS No. 128, *Earnings Per Share*, by dividing net income/(loss) by the weighted average number of common shares outstanding during the period. Our convertible preferred stock is considered a participating security, because the preferred stockholders are entitled to receive dividends when dividends are paid to common stockholders. We include the participating convertible preferred stock in the computation of earnings per share, using the two-class method in accordance with EITF No. 03-06, *Participating Securities and the Two-Class Method under FASB Statement No. 128*. Net income/(loss) per share (diluted) is calculated by adjusting the number of shares of common stock outstanding using the treasury stock method for options and warrants and the if converted method for convertible preferred stock and convertible debt, to the extent the effect of the converted portion on EPS is dilutive. Because we incurred a net loss for all periods, the diluted EPS calculation is the same as the basic EPS calculation.

As of March 31, 2009, the Company had granted 325,000 shares of restricted stock, of which 96,662 shares were vested.

As of the quarters ended March 31, 2009 and 2008 the shares used to calculate earnings per share are shown below.

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31,</b>
	<b>2009</b>	<b>2008</b>
Weighted average common shares outstanding		
Common	6,019,495	5,749,342
Common stock equivalents		
Number of shares used in per share computations	6,019,495	5,749,342

As of March 31, 2009 there were 228,338 shares of restricted stock, 18,750 shares of Series A preferred stock and 27,273 shares of Series B preferred stock outstanding which are convertible into a weighted average 4,329,570 common shares that were excluded from the earnings per share calculation as they were anti-dilutive.

**Note 3 Contract Receivables**

Contract receivables consist of the following (in thousands):

	<b>March 31,</b>	<b>December 31,</b>
	<b>2009</b>	<b>2008</b>
Completed contracts and contracts in progress (net of allowance)	\$ 23,351	\$ 24,494
Retainage	4,608	4,321
Completed contracts and contracts in progress related parties	2,240	2,938
Retainage related parties	1,551	1,747
Contract receivables	\$ 31,750	\$ 33,500

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**Note 4 Costs and Estimated Earnings on Incomplete Contracts and Backlog Information**

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

	<b>Total March 31, 2009</b>	<b>Corrections March 31, 2009</b>	<b>Commercial March 31, 2009</b>
Amended contract amount	\$ 292,201	\$ 236,443	\$ 55,758
Revenues recognized to date	232,387	187,854	44,533
Unearned contract amount backlog	\$ 59,814	\$ 48,589	\$ 11,225
Costs incurred to date	192,617	159,194	33,423
Estimated costs to complete	50,784	40,994	9,790
Estimated total cost	\$ 243,401	\$ 200,188	\$ 43,213
Billings to date	\$ 230,667	\$ 187,281	\$ 43,386
Costs and estimated earnings in excess of billings on incomplete contracts	\$ 8,181	\$ 5,585	\$ 2,597
Billing in excess of costs and estimated earnings on incomplete contracts	\$ 9,055	\$ 6,847	\$ 2,207
	<b>Total December 31, 2008</b>	<b>Corrections December 31, 2008</b>	<b>Commercial December 31, 2008</b>
Amended contract amount	\$ 310,588	\$ 237,456	\$ 73,132
Revenues recognized to date	237,126	178,388	58,738
Unearned contract amount backlog	\$ 73,462	\$ 59,068	\$ 14,394
Costs incurred to date	\$ 196,576	\$ 151,107	\$ 45,469
Estimated costs to complete	60,737	48,923	11,814
Estimated total cost	\$ 257,313	\$ 200,030	\$ 57,283
Billings to date	\$ 238,450	\$ 179,999	\$ 58,451
Costs and estimated earnings in excess of billings on incomplete contracts	\$ 6,475	\$ 4,277	\$ 2,198
Billing in excess of costs and estimated earnings on incomplete contracts	\$ 7,633	\$ 5,605	\$ 2,028

\* Backlog associated with PDI is not included in the table above for Total Company and Corrections Segment as the associated Revenues are not accounted for under the Percentage of Completion Method as defined in SOP 81-1.

The various subsidiary companies often function as subcontractors to other subsidiary companies. The Company reorganized in January 2008 to report the business in two segments – Argyle Corrections and Argyle Commercial Security (see Note 14). Since then the Company has determined that the most valid indicator of the next year's performance will be more closely tied to the Argyle Corrections backlog versus the Argyle Commercial Security backlog which is more volatile, given the shorter period typically required to complete the contracts.

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

Backlog is the result of the aggregate contract amount less revenues recognized to date using percentage-of-completion accounting (as described in Note 2 of these consolidated financial statements). The Company recognizes as backlog only those contracts for which it has received signed contracts and executed letters of intent to award a contract from its customers. As of the quarter ended March 31, 2009 backlog from nine letters of intent amounted to \$12.0 million. The Company also verifies that funding is in place on the contracts prior to inclusion in backlog.

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**Note 5 Long-Term Debt**

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

<b>Collateral</b>	<b>March 31, 2009</b>	<b>December 31, 2008</b>
Notes payable:		
Vehicles and equipment	\$ 377	\$ 418
Unsecured debt related party	11,508	11,393
Unsecured convertible debt stockholders		1,925
Seller notes	5,533	6,106
Line of credit and senior term debt	9,000	12,951
	\$ 26,418	\$ 32,793
Less current maturities	3,807	3,235
Long term debt	\$ 22,611	\$ 29,558

***Vehicles and Equipment***

Amounts attributed to vehicles and equipment in the above table include notes in favor of The Frost National Bank related to vehicles and various equipment lines. Vehicle and equipment notes are staggered with regard to their maturities, each amortizing over 36 – 48 month periods. Interest rates on the individual notes range from prime plus 1.0% to a fixed rate of 10.0%. The weighted average interest rate for these borrowings was 8.9% and 9.4% at March 31, 2009 and December 31, 2008, respectively. Argyle has agreed to guarantee the obligations of ISI under the notes up to \$1.0 million.

***Unsecured Debt Related Parties***

On January 2, 2008 an additional \$5.0 million in unsecured debt was funded to ISI by the same related party for which \$6.0 million was outstanding at December 31, 2007. All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreements contain prepayment options with prepayment penalties. Interest on the additional \$5.0 million of debt accrues at 11.58% per annum and is payable quarterly in arrears, deferred interest at the rate of 8.42% per annum, and default interest of an additional 2.0% per annum. The interest rate on all outstanding notes will increase by 4.0% if the outstanding notes are not repaid by September 30, 2010. The total debt of \$11.0 million plus accrued and unpaid interest is due and payable in one single payment on January 31, 2011. Argyle has agreed to guarantee the payment of the outstanding unsecured debt. There are both financial and restrictive covenants associated with the note agreements. As of March 31, 2009, ISI was in compliance or had received a waiver of non-compliance with all covenants. ISI expects to be in compliance with the modified covenants for the next year. On September 30, 2008, Argyle provided an unsecured, subordinated loan of \$2.0 million to ISI. The term of the loan was one month with the payment of all outstanding principal and accrued and unpaid interest due on October 31, 2008. The rate of interest was 6.0% per annum. The loan was repaid in full on October 3, 2008. On October 28, 2008, the Board approved Argyle's providing guarantees to ISI and its subsidiaries as an alternative to bonding, in an aggregate amount of up to \$15.0 million, in order to allow us the ability to bid projects without obtaining bonding.

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**ARGYLE SECURITY, INC.**  
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**Note 5 Long-Term Debt (continued)*****Unsecured Convertible Debt Stockholders***

As part of the merger consideration paid to acquire ISI, we issued unsecured convertible debt to the stockholders of ISI in the amount of \$1.9 million, at a rate of interest of 5.0% per annum, paid semiannually. The notes were able to be converted in whole or in part into shares of the Company's common stock at the election of the note holder at a share price of \$10.00 any time after January 1, 2008 or redeemed at the same price by the Company after January 1, 2009. On January 12, 2009, the notes were redeemed in full by the Company at \$10.00 per share for an aggregate of 192,763 shares of common stock.

In April 2007, our officers and directors, an affiliate of our Executive Chairman and Chief Executive Officer, and certain of our consultants, pursuant to a note and warrant acquisition agreement, loaned us an aggregate of \$300,000 and, in exchange, received promissory notes in the aggregate principal amount of \$300,000 and warrants to purchase an aggregate of up to 37,500 shares of common stock. The warrants are exercisable at \$5.50 per share of common stock and expire on January 24, 2011. The warrants also may be exercised on a net-share basis by the holders of the warrants. We have estimated, based upon a Black-Scholes model, that the fair value of the warrants on the date of issue was approximately \$2.48 per warrant (a total value of approximately \$93,000, using an expected life of two years, volatility of 2.39% and a risk-free rate of 5.0%). However, because the warrants have a limited trading history, the volatility assumption was based on information then available to management. The promissory notes had an interest at a rate of 4.0% per year and were repayable 30 days after the consummation of a business combination. The notes and the associated accrued interest were paid in full in August 2007.

***Seller Notes***

In connection with the PDI acquisition, ISI issued convertible promissory notes (the PDI Promissory Notes) in the aggregate principal amount of \$3.0 million. The aggregate principal amount of the PDI Promissory Notes may be reduced, depending on the occurrence of certain events described in the Asset Purchase Agreement. The payment of the PDI Promissory Notes is guaranteed by and secured by the assets of ISI and its subsidiaries, and they bear interest at 6.0% paid quarterly through December 2009. Argyle provided a guaranty of payment and performance of ISI's obligations under the PDI Promissory Notes. After December 2009, principal and interest payments of \$133,000 are due monthly with final payment occurring on December 31, 2011. From June 1, 2009 through November 15, 2009, we have the option to (i) convert \$500,000 of the outstanding principal into common stock of Argyle based on 95.0% of the closing price of the common stock for a 20-day trading period preceding notice of the Company's intent to convert; or (ii) extend the \$500,000 principal due in 2010 to January 3, 2011 for an additional payment of \$15,000 plus accrued interest. The aforementioned options to convert or extend the PDI Promissory Notes resulted in the creation of compound embedded derivatives for which the Company has performed valuations at the end of each fiscal quarter. The Company will mark to market the derivatives, for which any changes in fair value will be recognized in the statement of operations, in all the subsequent quarters until they are exercised or have expired. The valuation of these derivatives held a value of \$26,000 as of March 31, 2009.

In connection with the Com-Tec acquisition, ISI issued a secured subordinated promissory note in the aggregate principal amount of \$3.5 million (the Com-Tec Promissory Note). The Com-Tec Promissory Note is guaranteed by and secured by the assets of ISI and its subsidiaries, bears interest at 7.0% per year and have a maturity date of April 1, 2011. Argyle provided a guaranty of payment and performance of ISI's obligations under the Com-Tec Promissory Note. Interest only payments were made for each three-month period beginning on May 2008 and August 2008; a single principal payment of \$100,000 was due and paid on December 15, 2008; and level principal and interest payments in the cumulative amount of \$128,058 became due monthly beginning on August 1, 2008 and continuing monthly thereafter on the first day of each month for consecutive months through December 2008; then level principal and interest payments in the cumulative amount of \$123,748 became due monthly beginning on January 1, 2009, and continuing monthly thereafter on the first day of each month through December 2009, then for 25 consecutive months until the maturity date. On March 2, 2009, the principal of the Com-Tec Promissory Note was

reduced to \$3,491,291 as a result of adjustments made because of uncollected accounts receivable. Collectively, the PDI Promissory Notes and the Com-Tec Promissory Note are hereinafter referred to as the Seller Notes .



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**Note 5 Long-Term Debt (continued)**

***Senior Secured Credit Facility***

At March 31, 2009, ISI had a line of credit facility for (i) a secured revolving line of credit in the original amount of \$10.0 million with a \$5.0 million sublimit for the issuance of letters of credit, (ii) a secured revolving line of credit in the maximum amount of \$1.1 million, to be used solely for the issuance of letters of credit and (iii) a term loan in the original amount of \$10.0 million (collectively, the Loans ). The Loans mature on October 2, 2011. Upon closing, the proceeds were used to pay off existing indebtedness, with the remaining availability to be used for working capital and other general corporate purposes. Argyle agreed to provide a guaranty of the Loans up to \$18.1 million until the completion of an audit for the fiscal year ended 2009 (the Guaranty Agreement ); provided, however that the Guaranty Agreement will terminate on the earlier of (a) the payment in full of all obligations under the Loan Agreement or (b) at the time the Bank determines in its sole judgment that ISI s financial statements issued pursuant to the Loan Agreement for the fiscal year ended December 31, 2009 establish that ISI is in compliance with the amended financial covenants of the Loan Agreement. The line of credit that is used solely for letters of credit was decreased from \$5.0 million to \$1.1 million, and the promissory note evidencing the line of credit was amended and restated to reflect the principal amount reduction. The Loans will continue to be secured by liens on and security interests in the personal property of ISI and guaranteed by the subsidiaries of ISI.

The interest rates of the Loans are, at ISI s option from time to time, (i) a floating per annum rate of interest equal to the prime rate plus the Applicable Margin, or (ii) the LIBOR Rate plus the Applicable Margin. The Applicable Margin means the rate per annum added to the prime rate and LIBOR as determined by the ratio of total debt to EBITDA of ISI and its subsidiaries for the prior fiscal quarter. The weighted average interest rate for these borrowings was 6.0% and 5.9% at March 31, 2009 and December 31, 2008, respectively.

In connection with the Loans, the holders of each Seller Note agreed to be subordinated to the lender with respect to payment and perfection. In addition, the maturity dates of each Seller Note was effectively extended to be no earlier than the date on which all of the outstanding obligations of ISI to repay the outstanding principal and accrued and unpaid interest relating to the Loans are satisfied.

The agreement contains both financial and restrictive covenants, including a restriction on the payment of dividends by ISI. Under the terms of the credit facility, as of March 31, 2009, ISI is indebted for \$7.0 million in term debt and \$2.0 million through the line of credit. As of March 31, 2009, ISI was in compliance with all covenants.

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**Note 5 Long-Term Debt (continued)*****Interest Rate Risk Management***

The Company uses derivative instruments to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with changes in the London Inter-bank Offer Rate ( LIBOR ) applicable to its variable rate debt discussed above. The Company utilizes interest rate swap agreement to convert a portion of the variable rate debt to a fixed rate obligation. The Company accounts for its interest rate swaps in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

During the fourth quarter of 2008, the Company entered into a US dollar amortizing interest rate swap agreement, which became effective on December 1, 2008, with a notional amount starting at \$10.0 million. The notional amount of the swap is set to decrease periodically as set forth in the swap agreement. The hedging agreement duration matches the term length of the loan. The Company presents the fair value of the interest rate swap agreement at the end of the period in other long-term liabilities on its consolidated balance sheet. Fair values of the derivative instruments reported in the Consolidated Balance Sheet are as follows:

	<b>Balance Sheet</b>	<b>Fair Value</b>	
<b>Location</b>	<b>March 31,</b>	<b>December 31,</b>	<b>2008</b>
	<b>2009</b>		

**Derivative Liabilities:**

	Other long term		
Interest Rate Contracts	liabilities	\$ 189,973	\$ 188,001

At March 31, 2009, the interest rate swap had a fair value (net of taxes) of approximately \$117,214. During the quarter ended March 31, 2009, we recognized expense from hedging activities relating to interest rate swaps of \$26,392.

There were no ineffective amounts recognized during the period ended March 31, 2009, and we do not expect the hedging activities to result in an ineffectiveness being recognized in the earnings.

At March 31, 2009, accumulated other comprehensive income included a deferred pre-tax net loss of \$189,973 related to the interest rate swap. For the quarter ended March 31, 2009, we did not reclassify any pre-tax expense into interest expense from accumulated other comprehensive income as adjustments to interest payments on variable rate debt.

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**Note 6 Fair Value Measurement**

On January 1, 2008, the Company adopted the provisions of SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the quality of inputs used to measure fair value and enhances disclosure requirements for fair value measurements. The Company has applied SFAS 157 to all financial assets and liabilities that are being measured and reported at fair value on a recurring basis value effective January 1, 2008. In accordance with FSP FAS 157-2, the Company elected to defer application of SFAS No. 157 to nonfinancial assets and liabilities that are not recognized or disclosed at fair value in the consolidated financial statements on a recurring basis until January 1, 2009. The adoption of SFAS 157 for nonfinancial assets and liabilities on January 1, 2009 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

SFAS No. 157 establishes a three-tiered fair value hierarchy that prioritizes inputs to valuation techniques used in fair value calculations. The three levels of inputs are defined as follows:

Level 1 unadjusted quoted prices for identical assets or liabilities in active markets accessible by the Company.

Level 2 inputs that are observable in the marketplace other than those inputs classified as Level 1.

Level 3 inputs that are unobservable in the marketplace and significant to the valuation.

SFAS No. 157 requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs. If a financial instrument uses inputs that fall in different levels of the hierarchy, the instrument will be categorized based upon the lowest level of input that is significant to the fair value calculation.

The only asset or liability that is measured at fair value on a recurring basis other than the embedded derivative described in Note 5 is the liability for the Company's interest rate swap. The interest rate swap is valued in the market using discounted cash flow techniques which incorporate observable market inputs such as interest rates. These observable market inputs are utilized in the discounted cash flow calculation considering the instrument's term, notional amount, discount rate and credit risk. Significant inputs to the derivative valuation for interest rate swaps are observable in the active markets and are classified as Level 2 in the hierarchy.

Fair Value measurement as of March 31, 2009 and December 31, 2008:

	<b>Significant Other Observable Inputs (Level 2)</b>	
	<b>March 31, 2009</b>	<b>December 31, 2008</b>
<b>Liability</b>		
Interest Rate Swap (included in Other long term liabilities)	\$ 189,973	\$ 188,001

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**Note 7 Commitments**

We lease office space and equipment under operating leases expiring through 2012. The corporate office lease space in San Antonio, TX expired as of July 31, 2007, and we operated under a month-to-month lease arrangement until it was renewed in January 2008. The new lease expanded the space from approximately 2,500 square feet to 5,500 square feet for a total expense in 2008 of \$122,000 and \$32,000 for the first quarter of 2009. This lease expires in January 2013.

As part of the acquisition of PDI on January 4, 2008, ISI assumed PDI's existing leases in California and Arizona. On September 5, 2008, ISI entered into a lease relating to approximately 29,709 square feet of property located at 577 and 583 North Batavia Street, Orange, California. The term of the new lease is for two years commencing September 1, 2008 and ending August 31, 2010. The aggregate monthly base rent is \$16,934. In connection with the lease, on September 5, 2008, Argyle entered into a guaranty pursuant to which Argyle has agreed to guarantee the payment and performance obligations of ISI under the lease. The PDI lease in Arizona is a four year lease. The three facilities occupy a total of 55,709 square feet (26,000 square foot facility in Arizona and the 29,709 square foot facilities in California) with aggregate monthly payments of \$32,934.

As part of the Com-Tec acquisition that occurred at January 31, 2008, we signed a new lease for the existing facility. The Com-Tec lease is a five year lease, for the 33,000 square foot facility, with aggregate monthly payments of \$14,000 beginning in year three with the total rent expense being recognized on a straight-line basis over the life of the lease.

Rental expense was \$342,000 and \$196,000 for the three months ended March 31, 2009 and 2008, respectively.

In August 2007, we entered into a letter of credit facility with a financial institution. The letter of credit may not exceed \$500,000. The facility requires a 1.0% annual commitment fee on the unused portion of the letter of credit facility and is paid quarterly.

In May 2008, we entered into a letter of credit facility with a financial institution, secured by \$2.5 million of restricted cash. The letter of credit may not exceed \$2.5 million. The facility does not have a fee on the unused portion of the letter of credit facility.

In February 2009, Argyle entered into a letter of credit facility with the PrivateBank, collateralized by \$2.5 million in restricted cash. The letter of credit may not exceed \$2.5 million. The facility does not have a fee on the unused portion of the letter of credit facility.

**Note 8 Common Stock Reserved for Issuance**

As of March 31, 2009, 4,185,046 shares of common stock were reserved for issuance upon exercise of redeemable warrants and options, 375,000 shares of common stock were reserved for issuance pursuant to the underwriters' unit purchase option described in Note 10, and 4,602,300 shares of common stock were reserved for issuance pursuant to the preferred stock conversion option described in Note 9. This includes the warrants that were issued in connection with the April 2007 notes to stockholders which entitled the holder to exercise the warrants for a total of 37,500 shares of stock. In 2007, the Company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holders to exercise options for a total of 125,000 shares of stock and 130,000 shares of restricted stock (see Note 10). In 2008, the Company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holders to exercise options for a total of 100,000 shares of stock and 90,000 shares of restricted stock (see Note 10). In 2009, the Company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holders to exercise options for a total of 300,000 shares of stock and 135,000 shares of restricted stock (see Note 10).

In April 2008, the Company issued warrants for a total of up to 112,500 shares of stock exercisable at \$8.00 per share to Rodman & Renshaw as partial consideration in connection with the \$15.0 million Preferred Stock issuance completed in April 2008.



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**Note 9 Preferred Stock**

The Company is authorized to issue 1,000,000 shares of preferred stock with such designations, voting, and other rights and preferences, as may be determined from time to time by the Board of Directors. 46,023 shares of preferred stock are currently issued and outstanding.

In April 2008, the Company issued 18,750 shares of a newly created series of our preferred stock, designated Series A Convertible Preferred Stock, par value \$0.0001 per share pursuant to a \$15.0 million private placement. Each share of the Series A Convertible Preferred Stock accrues dividends at a rate greater of the declared dividend of the Company's common stock or 3.0% per annum. Such shares are convertible into 100 shares of the Company's common stock at any time at the option of the holder at a conversion price of \$8.00 per share. Upon liquidation (voluntary or otherwise), dissolution, winding up or a change of control of the Company (to the extent approved by the Company's Board of Directors), holders of the Series A Preferred Stock will be entitled to receive, from the assets of the Company available for distribution, the greater of the original issue price plus accrued but unpaid dividends or the amount the holder would receive if all the Series A Preferred Stock were converted into shares of Common Stock. Series A Convertible Preferred Stock holders have no voting rights.

On January 8, 2009, the Company issued 27,273 shares of a newly created series of our preferred stock, designated Series B Convertible Preferred Stock, par value \$0.0001 per share for \$110 per share, for an aggregate purchase price of \$3,000,030 less issuance costs of \$313,000. Each share of the Series B Preferred Stock is convertible into 100 shares of Common Stock at a conversion price of \$1.10 per share. The Series B Preferred Stock has voting rights equal to the number of shares of Common Stock the holder would receive if all Series B Preferred Stock had been converted into Common Stock. The holders of the Series B Preferred Stock may also designate one individual to serve on the Company's Board of Directors. The holders of the Series B Preferred Stock shall be entitled to receive, on a cumulative basis, cash dividends, when, as and if declared by the our Board of Directors, at the greater of (i) 4.0% per annum or (ii) the dividend payable on the equivalent amount of common stock into which the Series B Preferred Stock could be converted.

**Note 10 Stockholders Equity and Stock-Based Compensation**

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

**2005 2006 Options**

In July 2005, Argyle granted to its officers, directors, and their respective affiliates certain options, which were exercisable only in the event the underwriters exercised the over-allotment option, to purchase that number of shares enabling them to maintain their 20.0% ownership interest in the Company (without taking into account the units they purchased in the private placement). The measurement date was deemed to be January 30, 2006, the date the over-allotment was exercised because the number of options to be issued was not known until that date.

In January 2006, the underwriters exercised a portion of the over-allotment option in the amount of 75,046 units. In February 2006, the officers and directors exercised their options and purchased 18,761 units for an aggregate cost of \$507 (or \$0.027 per share). The compensation cost, recorded in operating expenses, resulting from these share-based payments was \$130,632 at January 30, 2006, using the Black-Scholes pricing model. This model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The fair value of the options was estimated at the measurement date using the assumptions of weighted-average volatility factor of 0.10, no expected dividend payments, weighted-average risk-free interest rate of 5.0%, and a weighted-average expected life of 0.13 years.

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



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**Note 10 Stockholders Equity and Stock-Based Compensation (continued)**

***Underwriter Options***

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

Argyle accounted for these purchase options as a cost of raising capital and included the instrument as equity in its consolidated balance sheet. Accordingly, there is no net impact on Argyle s financial position or results of operations, except for the recording of the \$100 proceeds from the sale. Argyle has estimated, based upon a Black-Scholes model, that the fair value of the purchase options on the date of sale was approximately \$3.40 per unit, (a total value of approximately \$0.6 million) using an expected life of five years, volatility of 44.0% and a risk-free rate of 5.0%. However, because Argyle s Units did not have a trading history, the volatility assumption was based on information then available to management. The volatility estimate was derived using historical data of comparable public companies in the proposed industry. Argyle believes the volatility estimate calculated from such comparable companies was a reasonable benchmark to use in estimating the expected volatility of our Units; however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.

***2007 Incentive Plan***

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

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

***Restricted Stock***

On January 25, 2008 and August 25, 2008, the Company granted an aggregate of 85,000 shares and 5,000 shares, respectively, of the Company s restricted common stock to certain of its executive officers and directors. Ability to sell, transfer or assign these shares vest December 31 in three equal tranches on each of December 31, 2008, 2009 and 2010.

On February 1, 2009, the Company granted 90,000 unregistered shares of our common stock to executive officers and key employees. Ability to sell, transfer or assign these shares vest December 31 in three equal tranches on each of 2009, 2010, and 2011. The holders have the right to vote all shares, regardless of the vesting schedule. On February 1, 2009 Sam Youngblood forfeited 30,000 of his restricted stock.

On March 19, 2009, the Company granted 45,000 unregistered shares of our common stock to three non-employee directors. These shares vest in full seven (7) days after the Director is no longer serving on the Board.

The total amount of restricted stock outstanding as of March 31, 2009 was 325,000 shares of which 96,662 shares are vested leaving 228,338 to vest in December, 31 2009, 2010 and 2011.



During the three months ended March 31, 2009, the Company recognized \$114,000 in compensation expense, net of deferred tax benefit of \$39,000, related to the Company's issuance of restricted stock. As of March 31, 2009, there was \$420,000 of unrecognized compensation costs, net of estimated forfeitures, related to the Company's non-vested restricted stock.

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**Note 10 Stockholders Equity and Stock-Based Compensation (continued)**

**Performance Unit Awards**

On January 25, 2008, the Company granted an aggregate of 55,000 performance unit awards to certain of its officers, subject to terms and conditions to be set forth in a performance unit award agreement and in accordance with the Company's 2007 Incentive Plan. These awards vest on December 31, 2010 and a cash payment is made to the holders only if certain performance goals to be determined by the Board of Directors are achieved. The Company recognizes compensation expense on the performance unit awards based on the fair value of the Company's underlying common stock at the end of each quarter over the remaining vesting period. Additionally, no compensation expense was recognized during the quarter ended March 31, 2009 for the grant of performance unit awards.

On February 1, 2009, the Company granted an aggregate of 110,000 performance unit awards to certain of its officers, subject to terms and conditions to be set forth in a performance unit award agreement and in accordance with the Company's 2007 Incentive Plan. These awards vest on December 31, 2011 and a cash payment is made to the holders only if certain performance goals to be determined by the Board of Directors are achieved. On February 1, 2009 Don Carr and Sam Youngblood forfeited 25,000 and 55,000 performance unit awards, respectively, leaving 205,000 total performance unit awards outstanding. The Company recognizes compensation expense on the performance unit awards based on the fair value of the Company's underlying common stock at the end of each quarter over the remaining vesting period. Additionally, no compensation expense was recognized during the quarter ended March 31, 2009 for the grant of performance unit awards.

**Incentive and Nonqualified Stock Options**

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

The Company has estimated, based upon a Black-Scholes model, that the fair value of the stock options granted on January 25, 2008 was approximately \$1.78 per option, (a total value of approximately \$178,000), using an expected life of three years, volatility of 40.0%, and a risk-free rate of 2.5%. However, because the shares did not have a trading history, the volatility assumption was based on information then available to management. The volatility estimate was derived using historical data of public companies in the related industry. The Company believes that the volatility estimate calculated from these companies was a reasonable benchmark to use in estimating the expected volatility of our units; however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.

On February 1, 2009, the Company granted stock options to purchase an aggregate of 300,000 shares of the Company's common stock to various employees, of which all were ISO. The options have a strike price of \$1.10 and vest in three equal tranches on each of December 31, 2009, 2010 and 2011.

The Company has estimated, based upon a Black-Scholes model, that the fair value of the stock options granted on February 1, 2009 was approximately \$0.07 per option, (a total value of approximately \$19,000), using an expected life of three years, volatility of 37.0%, and a risk-free rate of 1.0%. The Company's stock volatility rate was calculated by the Company's valuation specialist, which performed our goodwill and intangible impairment testing, based on the 1 year average of the twenty-day period volatility.

The total amount of stock options outstanding as of March 31, 2009 was 510,000 options of which 70,000 shares are vested leaving 440,000 to vest in December, 31 2009, 2010 and 2011.

During the three months ended March 31, 2009, the Company recognized \$31,000, in compensation expense, net of tax benefit of \$11,000 related to the Company's stock options. As of March 31, 2009, there was \$157,000 of unrecognized compensation costs, net of estimated forfeitures, related to the Company's non-vested stock options.

**Note 11 Income Taxes**

The provision (benefit) for income taxes was \$148,000 for the three months ended March 31, 2009 compared to (\$417,000) for the same period in 2008. The increase in income taxes of \$565,000 was primarily due to the increase in

income before income taxes in certain non-consolidated state jurisdictions. As a result of recording state tax expense in these jurisdictions, our effective tax rate was negative 178.3% for the three months ended March 31, 2009, compared to 36.2% for the same period in 2008.

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**Note 12 Other Comprehensive Income (Loss)**

Argyle follows SFAS No. 130, Reporting Comprehensive Income, in accounting for comprehensive income (loss) and its components. The components of other comprehensive income (loss) are as follows (dollars in thousands):

	<b>Three Months Ended March 31, 2009</b>		<b>Three Months Ended March 31, 2008</b>	
<b>Net income (loss)</b>	\$	(231)	\$	(734)
<b>Net unrealized gain (loss) on cash flow hedge</b>		25		0
<b>Reclassification adjustment for gain (loss) included in income, net of taxes</b>		(26)		0
<b>Other comprehensive income (loss)</b>	\$	(1)	\$	0
<b>Total comprehensive income (loss)</b>	\$	(232)	\$	(734)

**Note 13 Related-Party Transactions**

During the first quarter of 2008, the Company entered into a Board-approved agreement with Sec-Tec Global, Inc. (Sec-Tec) to share certain expenses related to common office space in New York, New York as well as administrative related expenses in the New York office. These expenses are being borne by the Company to reflect realistic expenses associated with the Company's conduct of business in New York. The Company has agreed to share expenses totaling \$185,000 on an annual basis that are to be paid in quarterly payments of \$43,750. During the three months ended March 31, 2009, the Company recognized \$46,250 in expenses related to this agreement. Sec-Tec is a wholly-owned subsidiary of Electronics Line 3000 of which the Company's Executive Chairman and CEO are stockholders and board members. See Note 16 Subsequent Events for information relating to the office space in New York, New York. At March 31, 2009 and 2008, other receivables include \$7,000 and \$47,000, respectively, of receivables from related parties, all of which is attributable to ISI. Amounts typically represent monies or other assets advanced to employees. The amounts in these employee receivables have been regularly paid, and management believes they are fully collectible.

The Company leases various properties from Green Wing Management, Ltd., an entity owned and controlled by the Chief Operating Officer and President of ISI, under capital leases. The leases on these properties include two that were amended as part of the acquisition of ISI to reflect a term of 12 years ending in 2019 and a new lease executed in June 2008. All leases require that an appraisal be completed by a qualified appraiser to determine the market rate of the leases. The rental rate to be paid on these properties, after the acquisition of ISI, is limited to no more than 90.0% of the market rate determined by the third-party appraiser. Additional appraisals by a third-party appraiser are to be conducted every three years during the 12-year terms, and the annual lease rate in the leases can increase at the time of these appraisals, but only to a level that does not to exceed 90.0% of the market rate determined by the third-party appraiser. Argyle has the right to purchase these three properties at any time, at the then current market value; however, the purchase price cannot be less than the value determined in the last appraisal preceding the effective date of the acquisition of ISI. During the quarter ended March 31, 2009, the Company made lease payments of \$123,000 under these leases.

In conjunction with the major refinancing of ISI in 2004, the majority stockholders formed a new company in 2004 (ISI\*MCS, Ltd.) which was used as the contracting entity on all future bonded contracts. ISI transferred certain existing bonded contracts at their remaining contract values, and no gain or loss was recognized on the transfers to ISI\*MCS, Ltd. at the time of its formation. All contracts of ISI\*MCS, Ltd. were subcontracted to ISI for the full contract amount, less a 2.0% fee. ISI recorded contract revenues based on the ISI\*MCS, Ltd. s contract amount, net of the 2.0% fee. Contract receivables from ISI\*MCS, Ltd. March 31, 2009 and December 31, 2008 totaled \$3.8 million and \$4.7 million, respectively, which is disclosed as Contract Receivables Related Party on the face of the consolidated balance sheet since ISI\*MCS, Ltd. is not consolidated in the balance sheet. Contract revenues reported by the Company from ISI\*MCS, Ltd. were \$0.9 million and \$6.9 million for the quarters ended March 31, 2009 and 2008, respectively. ISI\*MCS, Ltd. Argyle has agreed to indemnify the shareholders of ISI\*MCS, Ltd. from claims brought by the bonding company against their personal guarantees for those contracts that had not been paid in full as of the closing of the merger between Argyle and ISI. The merger agreement setting forth the agreements of Argyle and ISI provides that these indemnification obligations will survive for a period of four years after the closing date of the merger and the obligations are not subject to cap, or maximum amount. ISI will receive 100.0% of the remaining contract amounts and ISI\*MCS, Ltd. will forego its 2.0% fee. Remaining amounts to be billed on these contracts, as of March 31, 2009, totaled \$1.4 million. Beginning July 31, 2007, all future contracts, bonded and un-bonded, are being contracted directly by the Company without involvement by ISI\*MCS, Ltd.

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**Note 13 Related-Party Transactions (continued)**

As part of the merger of Argyle and ISI, debt totaling \$16.0 million was owed to a shareholder of ISI, of which \$10.0 million was paid prior to its scheduled payment terms. As a part of the merger, the shareholder of ISI became a shareholder of Argyle, holding 486,237 shares of Argyle common stock as of July 31, 2007 and, as such, also becoming a related party. At March 31, 2009 and December 31, 2008, the remaining debt to the shareholder (see Note 5) totaled \$11.5 million and \$11.4 million, respectively.

On September 30, 2008, Argyle provided an unsecured, subordinated loan of \$2.0 million to ISI. The term of the loan was one month with the payment of all outstanding principal and accrued and unpaid interest due on October 31, 2008. The rate of interest was 6.0% per annum. The loan was repaid in full on October 3, 2008.

On October 28, 2008, the Board approved the Company's providing guarantees to ISI and its subsidiaries as an alternative to bonding, in an aggregate amount of up to \$15.0 million, in order to allow ISI the ability to bid projects without obtaining bonding.

**Note 14 Segment Information**

Argyle has two reporting segments: Argyle Corrections and Argyle Commercial Security.

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

Argyle Corrections consists of all of our businesses in the corrections sector, including MCS-Detention, ISI-Detention, as well as Com-Tec and PDI. Com-Tec and PDI were acquired in January 2008. Argyle Corrections includes:

- MCS-Detention, which designs, engineers, supplies, installs and maintains complex, customized physical and software security solutions, access control, video and electronic security control system solutions at correctional and government facilities;

- ISI -Detention, which designs, engineers, supplies, installs and maintains a full array of detention systems and equipment, targeting correctional facilities throughout the United States;

- PDI, which is a full-service, turnkey solutions provider that manufactures high security metal barriers, high security observation window systems, detention furniture and accessories; and

- Com-Tec, which is an industry leader in the custom design and manufacture of electronic security and communications systems at federal, state and private correctional facilities, city and county jails and police stations.

Argyle Commercial Security has built a parallel business to Argyle Corrections, targeting commercial, industrial and governmental facilities. Argyle Commercial Security focuses on the commercial security sector and provides turnkey, electronic security systems to the commercial market. Currently, MCS Commercial Fire & Security, referred to historically as MCS-Commercial, operates out of its own San Antonio headquarters and five regional offices. The offices in Austin, Houston and Denver resulted from acquisitions made by ISI before it was acquired by Argyle. Argyle Federal Systems is currently a newly operational business unit which focuses on providing security solutions and services targeted at the federal government.



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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

**Note 14 Segment Information (continued)**

**Summary Segment Information**  
(in thousands)

<b>Industry Segment (in thousands)</b>	<b>Three Months Ended March 31, 2009</b>		<b>Three Months Ended March 31, 2008</b>	
Revenues:				
Corrections	\$	21,873	\$	30,038
Commercial		9,871		7,559
Corporate				
Eliminations				
<b>Total</b>	<b>\$</b>	<b>31,744</b>	<b>\$</b>	<b>37,597</b>
Operating income (loss):				
Corrections	\$	1,102	\$	1,610
Commercial		915		(136)
Corporate		(1,242)		(1,852)
Eliminations				
<b>Total</b>	<b>\$</b>	<b>775</b>	<b>\$</b>	<b>(378)</b>
Capital expenditures:				
Corrections	\$	243	\$	650
Commercial		45		121
Corporate		3		10
<b>Total</b>	<b>\$</b>	<b>291</b>	<b>\$</b>	<b>781</b>
Total assets:				
Corrections	\$	58,880	\$	99,920
Commercial		11,153		5,752
Corporate		24,137		37,353
Eliminations		(13,392)		(34,158)
<b>Total</b>	<b>\$</b>	<b>80,778</b>	<b>\$</b>	<b>108,867</b>



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**ARGYLE SECURITY, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**

**Note 15 Supplemental Disclosures of Cash Flow Information (in thousands)**

	<b>Three Months Ended</b>	
	<b>March 31, 2009</b>	<b>March 31, 2008</b>
Cash paid for interest	\$ 309	\$ 489
Cash paid for income taxes	2	300
<b>Supplemental schedule of non-cash investing activities:</b>		
Financed purchases of property and equipment	\$	\$
Issuance of stock to retire notes with related parties	1,925	
Accrual for transaction costs		405
<b>Supplemental schedule of non-cash financing activities:</b>		
Notes issued for acquisitions	\$	\$ 6,765
Dividends accrued	143	
Accrual of offering costs		302

**Note 16 Subsequent Events**

On April 24, 2009, ISI and each of the holders of the PDI Promissory Notes entered into an amendment to correct a ministerial error whereby the maturity date as defined in each PDI Promissory Note did not accurately correspond with the business understanding of the parties and the payments being made under the repayment schedule. This ministerial error does not have any impact on our prior financial reports.

On April 30, 2009, Argyle entered into a Lease Agreement (the "NY Lease") relating to approximately 1,350 square feet of property located at 40 West 37<sup>th</sup> Street, New York, NY (the "NY Office"). The term of the NY Lease is for one year commencing May 11, 2009 and ending May 31, 2010. The monthly base rent is \$3,656. In connection with entering into the NY Lease, Argyle terminated its existing cost-sharing arrangement with Sec-Tec relating to the office space in New York, NY whereby Argyle had paid Sec-Tec an aggregate of \$185,000 per year. Sec-Tec has agreed to permit Argyle to use certain of Sec-Tec's furniture and equipment in the NY Office. In addition, in consideration for terminating the cost-sharing arrangement, Argyle will permit Sec-Tec to utilize one telephone line and, if available and needed, a portion of the NY Office.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

**Overview**

Argyle Security, Inc. (formerly Argyle Security Acquisition Corporation) ( *Argyle* ) was incorporated in Delaware in June 2005 to acquire, through merger, capital stock exchange, asset acquisition, or other similar business combination, a business in the security industry. Argyle completed its initial public offering in January 2006. On July 31, 2007, Argyle consummated its initial acquisition through the acquisition of 100.0% of the outstanding capital stock of ISI Security Group, Inc. (f/k/a ISI Detention Contracting Group, Inc., referred to herein as *ISI* ) and its subsidiaries. As a result of the merger, ISI became a wholly owned subsidiary of Argyle. When used herein, *Argyle* , the *Company* , *we* , *us* , *our* , refers to the pre-acquisition company until July 31, 2007 and the post-acquisition company after July 31, 2007.

Argyle is a comprehensive security solutions provider to our diverse customer base because it addresses the majority of their physical electronic security requirements. Argyle is a detention and commercial equipment contractor that specializes in designing and integrating security solutions, including turnkey installations, design, engineering, supply, and installation of various detention, surveillance and access control equipment and software solutions for correctional facilities and commercial institutions. The work is generally performed under fixed-price contracts. The projects are located in various cities throughout the United States. The length of the contracts varies but is typically less than two years. Argyle also provides turnkey installations covering the full spectrum of electronic security and low voltage systems, including fire alarm, access control, closed circuit television, intercom, sound/paging and other custom designed systems.

In February 2008, we organized our business under the name of *Argyle Security USA* and then, in January 2009, we eliminated the name *Argyle Security USA* and, for the sole purpose of debt covenant compliance calculation which only considers the operating business financial condition, organized the operational business of Argyle under the name *Argyle Security Operations* , or *ASO* , through which we provide security solutions to commercial, governmental and correctional customers. Argyle has two reporting segments or business divisions: *Argyle Corrections* and *Argyle Commercial Security* .

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

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

MCS (also referred to as MCS-Detention), which designs, engineers, supplies, installs and maintains complex, customized physical and software security solutions, access control, video and electronic security control system solutions at correctional and government facilities;

ISI-Detention, which designs, engineers, supplies, installs and maintains a full array of detention systems and equipment, targeting correctional facilities throughout the United States;

PDI, which is a full-service, turnkey solutions provider that manufactures high-security metal barriers, high-security observation window systems, detention furniture and accessories; and

Com-Tec, which is an industry leader in the custom design and manufacture of electronic security and communications systems at federal, state and private correctional facilities, city and county jails and police stations.

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Argyle Commercial Security has built a parallel business to Argyle Corrections, targeting commercial, industrial and governmental facilities. Argyle Commercial Security focuses on the commercial security sector and provides turnkey, electronic security systems to the commercial market. Currently, MCS Commercial Fire & Security, referred to as MCS-Commercial, operates out of its own San Antonio headquarters and five regional offices in Texas and Colorado. The offices in Austin, Houston, and Denver resulted from acquisitions made by ISI before it was acquired by Argyle. Its security systems cover access control, video systems, intrusion detection systems, proximity and smart cards, biometric technology, photo identification (ID) printers and supplies among others. It also secures the community by leveraging leading edge technology through installation of intelligent perimeter security, wireless video, IP video and intelligent video surveillance. Its industry-leading fire detection systems include QuickStart, EST2 & EST3, integrated life support systems, control panels, detectors, and audible and visible signals. Argyle Federal Systems is currently a newly operational business unit which focuses on providing security solutions and services targeted at the federal government. In November 2008, Argyle Commercial Security was awarded a supply contract through the U.S. General Services Administration ( GSA ) to provide integrated security solutions and products to the various departments in the United States federal government and any other entity that purchases off the GSA contract. These solutions and products consist of Access Control, Video, Perimeter Security and ID Credentials that have been very successful in the commercial marketplace, and now will be available to all governmental entities with access to the GSA contracts.

The following is an illustration of our business segments and business units.

**Table of Contents****Critical Accounting Policies**

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

*Percentage-of-Completion Estimates* Other than for PDI, our business units each uses percentage-of-completion accounting to determine revenue and gross margin earned on projects. Estimating the percentage-of-completion on a project is a critical estimate used when budgeting for its projects. This estimate is determined as follows:

The contract amount and all contract estimates are input into a job cost accounting system with detail of all significant estimates of purchases by vendor type, subcontractor and labor.

As the project is performed and purchases and costs are incurred, these are recorded in the same detail as the original estimate.

The contract amount and estimated contract costs are updated monthly to record the effect of any contract change order received.

On a monthly basis, management, along with project managers who are overseeing the contracts, review these estimated costs to complete the project and compare them to the original estimate and the estimate that was used in the prior month to determine the percentage-of-completion. If the cost to complete, determined by management and the project managers for the current month, confirms that the estimate used in the prior month is correct, then no action is taken to change the estimate and/or the percentage complete in that current month. However, if the current cost-to-complete estimate calculated by the management and the project managers differ, then adjustments are made. If the costs are in excess of the estimate used in the prior month, then a decrease in the percentage complete on the project through the current month in the accounting period is made. If the costs are less than the estimate used in the prior accounting period, then the new estimate increases the percentage complete on the project.

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

These estimates of project percentage-of-completion of a project determine the amounts of revenues and gross margin that are earned to date on a project. For example, if a contract is \$100,000 with a 20.0% gross margin of \$20,000, then a project that is estimated to be 50.0% complete accrues \$50,000 in revenues and \$10,000 in gross margin. If the percentage completed is adjusted to 25.0%, then the revenues on the contract would be \$25,000, and the earned gross margin would be \$5,000. These estimates would be changed in the current month, and the actual accrual of the revenues and gross margin earned on this project would be reduced in the current month.



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During the three months ended March 31, 2009, the Company conducted regular reviews and evaluations for the cost estimates associated with all of the approximately 1,300 active construction contracts in the Company's Work-in-Process. Changes in cost estimates come as the result of customer-ordered change orders, changes in material or labor costs and issues associated with managing the projects. As a result of the review the cost estimates for the in-process construction contracts (that existed as of quarter ended March 31, 2009) increased by a net \$1.7 million in quarter ended March 31, 2009. Of the aforementioned net estimated cost increases of \$1.7 million, 11 contracts had cost estimate changes of approximately \$100,000 or greater resulting in \$1.6 million. Eight of the total 11 of the contracts with changes greater than \$100,000 resulted in cost estimate increases totaling \$2.0 million while three contracts had estimated cost decreases totaling \$400,000. Approximately 1,260 of the remaining contracts with variances of less than \$100,000 resulted in a net decrease in cost estimates of \$2,000.

Another effect of the change in the estimated costs and percentage complete is that it changes the percentage of Gross Margin earned. For example, in the aforementioned project, if the estimated costs changed to 90.0% from 80.0% because of projected cost overruns, this would then reduce the gross margin percentage to 10.0% from 20.0%.

Management attempts to recognize losses (overruns of cost estimates) as soon as they can be quantified. Management attempts to recognize gains (under-runs of cost estimates) when they can be quantified and are certain.

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

The current asset *Costs and Estimated Earnings in Excess of Billings on Incomplete Contracts* represents revenues recognized in excess of amounts billed which management believes will be billed and collected within the subsequent year. The current liability *Billings in Excess of Costs and Estimated Earnings on Incomplete Contracts* represents billings in excess of revenues recognized.

*Revenue Recognition for Shipped Products* Revenues are recognized by PDI when the product is shipped to the customer in accordance with the contractual shipping terms. In almost all cases, the shipping of products to PDI's customers is FOB Origin, whereby title passes to the purchaser when the product leaves the PDI premises under the bail of a common carrier. In only rare instances (less than 2.0% of all shipments), are products shipped to PDI customers as FOB Destination, whereby title passes to the purchaser when the product reaches the destination. When delivery to the customer's delivery site has occurred, the customer takes title and assumes the risks and rewards of ownership.

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

*IBNR Estimates for Health Insurance* On a quarterly basis, Argyle estimates its health insurance cost, for its self-insured employee base at the acquired companies, ISI, PDI and Com-Tec, based upon expected health insurance claims for the current year. The insurance company which provides both the stop-loss and total aggregate insurance coverage also provides the average or expected and maximum claims for each class. The average and maximum claims are based on our demographics and prior claim history. Argyle uses the average claims history for the trailing the 12 months as its basis for accruing health care cost.

*Sales and Use Taxes* The Company collects and remits taxes on behalf of various state and local tax authorities. For the quarter ended March 31, 2009, the Company collected \$334,000 and remitted \$420,000 in taxes. Sales and use taxes are reflected in the general and administrative expenses.

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

*Allowance for Doubtful Accounts* Argyle provides an allowance for bad debt through an analysis in which the bad debts that had been written off over previous periods are compared on a percentage basis to the aggregate sales for the same periods. The resulting percentage is applied to the year-to-date sales and a monthly reserve is accrued

accordingly. Additionally, management analyzes specific customer accounts receivable for any potentially uncollectible accounts and will add such accounts to the reserve or write them off if warranted, after considering lien and bond rights, and then considers the adequacy of the remaining unallocated reserve compared to the remaining accounts receivable balance (net of specific doubtful accounts).



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*Impairment of Long-lived Intangible Assets* Long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable. Examples include a significant adverse change in the extent or manner in which we use a long-lived asset or a change in its physical condition. When evaluating long-lived assets for impairment, we compare the carrying value of the asset to the asset's estimated undiscounted future cash flows. Impairment is indicated if the estimated future cash flows are less than the carrying value of the asset. The impairment is the excess of the carrying value over the fair value of the long-lived asset. Our impairment analysis contains uncertainties due to judgment in assumptions and estimates surrounding undiscounted future cash flows of the long-lived asset, including forecasting useful lives of assets and selecting the discount rate that reflects the risk inherent in future cash flows to determine fair value.

We have not made any material changes in the accounting methodology used to evaluate the impairment of long-lived assets during the last two fiscal years. We do not believe there is a reasonable likelihood there will be a material change in the estimates or assumptions used to calculate impairments of long-lived assets. The Company's discount rate, the Weighted Average Cost of Capital ( WACC ) and the growth rates assumed for revenues have not changed significantly in the last two planning cycles given the last two years of operations. However, if actual results are not consistent with our estimates and assumptions used to calculate estimated future cash flows, we may be exposed to impairment losses that could be material.

*Goodwill* Represents the excess of the purchase price over the fair value of net assets acquired, including the amount assigned to identifiable intangible assets. Goodwill is reviewed for impairment annually, or more frequently if impairment indicators arise. Our annual impairment review requires extensive use of accounting judgment and financial estimates. The analysis of potential impairment of goodwill requires a two-step process. The first step is to identify if a potential impairment exists by comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to have a potential impairment, and the second step of the impairment test is not necessary. However, if the carrying amount of a reporting unit exceeds its fair value, the second step is performed to determine if goodwill is impaired and to measure the amount of impairment loss to recognize, if any.

The second step compares the implied fair value of goodwill with the carrying amount of goodwill. If the implied fair value of goodwill exceeds the carrying amount, then goodwill is not considered impaired. However, if the carrying amount of goodwill exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess.

The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination (i.e., the fair value of the reporting unit is allocated to all the assets and liabilities, including any unrecognized intangible assets, as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit were the purchase price paid to acquire the reporting unit).

We have elected to make the first day of the third quarter the annual impairment assessment date for goodwill and other intangible assets. However, we could be required to evaluate the recoverability of goodwill and other intangible assets prior to the required annual assessment if we experience disruptions to the business, unexpected significant declines in operating results, divestiture of a significant component of the business or a sustained decline in market capitalization.

The Company identified its reporting units under the guidance of SFAS 142 Goodwill and Other Intangible Assets (FAS 142) and EITF Topic D-101, Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142. The Company's reporting units are ISI-Detention, MCS-Detention, PDI, Com-Tec (which comprise the Argyle Corrections business segment), and MCS-Commercial which comprises the Argyle Commercial Security business segment.

We estimate the fair value of our reporting units, using various valuation techniques, with the primary technique being a discounted cash flow analysis. A discounted cash flow analysis requires us to make various judgmental assumptions about sales, operating margins, growth rates and discount rates. Assumptions about sales, operating margins and growth rates are based on our budgets, business plans, economic projections, anticipated future cash flows and marketplace data. Assumptions are also made for varying perpetual growth rates for periods beyond the long-term business plan period.



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Other intangible asset fair values have been calculated for trademarks using a relief from royalty rate method and using the present value of future cash flows for patents and in-process technology. Assumptions about royalty rates are based on the rates at which similar brands and trademarks are licensed in the marketplace.

Our impairment analysis contains uncertainties due to uncontrollable events that could positively or negatively impact the anticipated future economic and operating conditions. We have not made any material changes in the accounting methodology used to evaluate impairment of goodwill and other intangible assets during the last two years.

While we believe we have made reasonable estimates and assumptions to calculate the fair value of the reporting units and other intangible assets, it is possible a material change could occur. If our actual results are not consistent with our estimates and assumptions used to calculate fair value, we may be required to perform the second step in future periods which could result in further impairments of our remaining goodwill.

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

Purchase options (ISO / non-qualified) grants:

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

Restricted stock and performance unit award grants:

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

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

**Table of Contents****Explanatory Note Relating to Pro Forma Financial Information**

Because we acquired ISI in July 2007, and Fire Quest, PDI and Com-Tec in January 2008, we previously presented a Management's Discussion and Analysis of Financial Condition in our Annual and Quarterly Reports which included the pro forma and adjusted pro forma results of operations for the Company and the acquisitions as if the acquisitions occurred on January 1, 2008 and January 1, 2007, respectively. We have concluded that because, other than Com-Tec which acquisition was effective on January 31, 2008, all acquired companies were included in the three month period ended March 31, 2008 that the pro forma presentation is no longer beneficial to our stockholders and such presentation has not been included in the Management's Discussion and Analysis of Financial Condition section of this report. The results of operations of Com-Tec for the one month ended January 31, 2008 are not reflected in the consolidated financial statements for the Company for the three months ended March 31, 2008.

**Non-GAAP Presentation**

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

Below is a reconciliation of GAAP Net Income (Loss) to EBITDA. **The presentation of EBITDA is not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with GAAP.**

**Reconciliation of GAAP Net Income (Loss) to EBITDA**

(unaudited)  
(in thousands)

	<b>Three Months Ended</b>	
	<b>March 31, 2009</b>	<b>March 31, 2008</b>
<b>GAAP net income (loss)</b>	<b>\$ (231)</b>	<b>\$ (734)</b>
Interest, net	858	773
Depreciation	464	490
Amortization	451	1,731
Taxes, net	148	(417)
<b>EBITDA</b>	<b>\$ 1,690</b>	<b>\$ 1,843</b>
<b>Weighted average common shares outstanding</b> <b>basic</b>	<b>6,019,495</b>	<b>5,749,342</b>
<b>Weighted average common shares outstanding</b> <b>diluted</b>	<b>6,019,495</b>	<b>5,749,342</b>

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Below is a table of revenues, cost of revenues and gross margins for the three months ended March 31, 2009 and 2008.

	Three Months Ended March 31, 2009			Three Months Ended March 31, 2008			Percent Increase (Decrease)		
	Correction	Commercial	Total	Correction	Commercial	Total	Correction	Commercial	Total
Net revenues									
Contract revenues and contract revenues related party	\$ 18,352	\$ 7,834	\$ 26,186	\$ 28,205	\$ 5,598	\$ 33,803	(34.9%)	39.9%	(22.5%)
Manufacturing revenues	1,901		1,901	1,518		1,518	25.2%	0.0%	25.2%
Service and other revenues	1,620	2,037	3,657	316	1,960	2,276	412.7%	3.9%	60.7%
Total net revenues	\$ 21,873	\$ 9,871	\$ 31,744	\$ 30,039	\$ 7,558	\$ 37,597	(27.2%)	30.6%	(15.6%)
<i>% of total</i>	<i>68.9%</i>	<i>31.1%</i>		<i>79.9%</i>	<i>20.1%</i>				
Cost of revenues									
Contract costs and contract costs related party	\$ 15,217	\$ 6,115	\$ 21,332	\$ 22,897	\$ 4,445	\$ 27,342	(33.5%)	37.6%	(22.0%)
Manufacturing costs	1,258		1,258	690		690	82.3%	0.0%	82.3%
Service and other costs	1,046	1,451	2,497	1,398	1,763	3,161	(25.2%)	(17.7%)	(21.0%)
Total cost of revenues	\$ 17,521	\$ 7,566	\$ 25,087	\$ 24,985	\$ 6,208	\$ 31,193	(29.9%)	21.9%	(19.6%)
Gross margin									
Contract margins and contract margins related party	\$ 3,135	\$ 1,719	\$ 4,854	\$ 5,308	\$ 1,153	\$ 6,461	(40.9%)	49.1%	(24.9%)
Manufacturing margins	\$ 643	\$	\$ 643	\$ 828	\$	\$ 828	(22.3%)	0.0%	(22.3%)
Service and other margins	574	586	1,160	(1,082)	197	(885)	153.0%	197.5%	(231.1%)
Total gross margin	\$ 4,352	\$ 2,305	\$ 6,657	\$ 5,054	\$ 1,350	\$ 6,404	(13.9%)	70.7%	4.0%

Gross margin percentage									
Contract revenues and contract revenues related party	17.1%	21.9%	18.5%	18.8%	20.6%	19.1%	(9.0%)	6.3%	(3.1%)
Manufacturing margins	33.8%	0.0%	33.8%	54.5%	0.0%	54.5%	(38.0%)	0.0%	(38.0%)
Service and other revenues	35.4%	28.8%	31.7%	(342.4%)	10.1%	(38.9%)	110.3%	185.1%	(181.5%)
Total gross margin percentage	19.9%	23.4%	21.0%	16.8%	17.9%	17.0%	18.5%	30.7%	23.5%

**Table of Contents****Results of Operations for the Three Months Ended March 31, 2009 and 2008**

The following table sets forth, for the three months ended March 31, 2009 and 2008, certain operating information expressed in U.S. dollars (in thousands):

	Three Months March 31, 2009		Three Months March 31, 2008		Year to Year Increase (Decrease)	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
<b>Revenues:</b>						
<b>Contract revenues</b>	\$ 25,326	79.8%	\$ 26,860	71.4%	\$ (1,534)	(5.7%)
<b>Contract revenues related party</b>	860	2.7%	6,943	18.5%	(6,083)	(87.6%)
<b>Manufacturing revenues</b>	1,901	6.0%	1,518	4.0%	383	25.2%
<b>Service and other revenues</b>	3,657	11.5%	2,276	6.1%	1,381	60.7%
<b>Total revenues</b>	<b>\$ 31,744</b>	<b>100.0%</b>	<b>\$ 37,597</b>	<b>100.0%</b>	<b>\$ (5,853)</b>	<b>(15.6%)</b>
<b>Cost of Revenues:</b>						
<b>Contract costs</b>	\$ 21,332	67.2%	\$ 27,342	72.7%	\$ (6,010)	(22.0%)
<b>Manufacturing costs</b>	1,258	4.0%	690	1.8%	568	82.3%
<b>Service and other costs, including amortization of intangibles</b>	2,497	7.9%	3,161	8.4%	(664)	(21.0%)
<b>Cost of revenues</b>	<b>\$ 25,087</b>	<b>79.0%</b>	<b>\$ 31,193</b>	<b>83.0%</b>	<b>\$ (6,106)</b>	<b>(19.6%)</b>
<b>Gross profit</b>	<b>\$ 6,657</b>	<b>21.0%</b>	<b>\$ 6,404</b>	<b>17.0%</b>	<b>\$ 253</b>	<b>4.0%</b>
<b>Total operating expenses</b>	<b>\$ 5,882</b>	<b>18.5%</b>	<b>\$ 6,782</b>	<b>18.0%</b>	<b>\$ (900)</b>	<b>(13.3%)</b>
<b>Other income (expense):</b>						
<b>Interest income</b>	\$ 25	0.1%	\$ 26	0.1%	\$ (1)	(3.8%)
<b>Interest expense</b>	(883)	(2.8%)	(799)	(2.1%)	(84)	10.5%
<b>Total other income (expense)</b>	<b>\$ (858)</b>	<b>(2.7%)</b>	<b>\$ (773)</b>	<b>(2.1%)</b>	<b>\$ (85)</b>	<b>11.0%</b>
<b>Net income (loss)</b>	<b>\$ (231)</b>	<b>(0.7%)</b>	<b>\$ (734)</b>	<b>(2.0%)</b>	<b>\$ 503</b>	<b>(68.5%)</b>
<b>EBITDA</b>	<b>\$ 1,690</b>	<b>5.3%</b>	<b>\$ 1,843</b>	<b>4.9%</b>	<b>\$ (153)</b>	<b>(8.3%)</b>

**Revenues**

More than 92.0% of our revenues are generated by fixed-price contracts (both hard-bid and design-build contracts). The success of a fixed-price contract is based in large part upon the quality of the process utilized when estimating the costs that will be incurred in performing the contract. The larger the project and the longer the term of completion of the contract, the greater the number of variable factors there are to be considered and evaluated in estimating costs. A successful estimating process requires substantial experience and judgment. Management is aware of the significant

need for experienced and qualified estimating personnel and regularly monitors the estimating process and its results. The most obvious benchmark that management considers in evaluating the estimating process is whether the amount estimated, and submitted as a bid, was reasonably similar to the amount bid by our competitors on the same project. If possible, management evaluates the bids that were submitted in competition with our bid, based on their knowledge of each competitor's history and character (for example, some typically bid high, some typically bid low), the condition of the market, the complexity of the project, the type of construction and other factors. This review provides management with an ongoing general basis for evaluating the estimating process that result in fixed-price contracts. Evaluating the results of bidding competitions allows management to evaluate the Company's estimating capabilities at the beginning or front end of a new contract or project. Other benchmarks are used to evaluate the estimating process while a project is ongoing.

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



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Typically, new bookings will result in revenues within three to six months due to the incubation period for construction projects. Despite an increase in market share, shortfalls in anticipated new sales bookings in the second half of 2008 has caused a negative impact on revenue in the first three months of 2009. We have also seen a decrease in new bookings in the first quarter of 2009 compared to the same period in 2008. This shortfall was primarily due to a slowdown in the activity of larger private prison developers. The slowdown has been primarily caused by the turbulent and uncertain economy, which is reducing availability of financing and state and municipal tax revenues. We have, however, seen that the number of new projects for smaller, boutique private prison operators has increased and that the volume of pending work (which is quoted work, waiting on a customer's final decision to buy) for these projects has increased over the past few months. We believe that the projects involving larger private prison operators and state and federal-run prisons will likely continue to be slower given the current deterioration in the state of the general economy. Any decrease in the number and amount of new bookings or lower margins to be realized from newly booked projects will not likely have a material effect on revenues until 2010.

We had revenues of \$31.7 million (including related party revenues of \$0.9 million) and \$37.6 million (including related party revenues of \$6.9 million) for the three months ended March 31, 2009 and 2008, respectively, representing a decrease of \$5.9 million or 15.6%. In 2008, Argyle Corrections saw significant revenue growth due to an increase in the number of projects booked during 2007 when the U.S. economy was more robust. During 2008, the number of projects booked was lower because of the overall slowdown of the U.S. economy and a more challenging debt-financing market for larger private prison developers. The revenue mix was 82.5% contract revenues and 17.5% manufacturing, service and other revenues for the three months ended March 31, 2009 compared to 89.9% and 10.1%, respectively, for the corresponding period in 2008. Manufacturing revenues, included in service and other revenues represented 6.0% of total revenues in 2009 and 4.0% in 2008.

Year-over-year service and other revenues increased by \$1.4 million, or 61%, to \$3.7 million for the three months ended March 31, 2009 versus the same period in 2008. This increase was largely attributable to one particular service job performed by ISI Detention, involving a major retrofit of an existing facility following a prison riot, which generated aggregate time and material billings of \$1.1 million. Other business units also experienced more modest increases in their service revenues in the quarter over 2008.

As used in this analysis, related party revenues are revenues which are generated by work subcontracted from ISI\*MCS (an entity owned by Sam Youngblood and by Don Carr). Messrs. Youngblood and Carr created ISI\*MCS in 2004 to provide bonding on contracts that required bonding. The performance of those contracts was subcontracted to ISI as a subcontractor to ISI\*MCS. The subcontracted work was for third party customers of ISI\*MCS that required bonded contracts. Since the acquisition of ISI by Argyle, ISI\*MCS no longer provides bonding and subcontract work to ISI. We have secured our own bonding capacity and will use that bonding capacity to directly enter into bonded contracts with third-party customers. As a result, the amount of related party revenues will continue to decrease as the contracts with ISI\*MCS outstanding at the time of the merger are completed.

**Cost of Revenues**

Cost of revenues consists of the direct costs to complete a fixed-price contract (both hard bid and design build contracts) and includes variable costs related to the project, such as material, direct labor, project management costs, travel related expenses to the projects, hotel costs spent while the project is on-going, and truck expenses utilized on those projects. Additionally, the amortization of acquired backlog has been included in our cost of revenues. Further, we also review our inventories for indications of obsolescence or impairment and provide reserves as deemed necessary.

Cost of revenues decreased by \$6.1 million, or 19.6%, to \$25.1 million for the three months ended March 31, 2009, compared to \$31.2 million for the corresponding period in 2008. The decrease in cost of revenues resulted from working on fewer projects in the first three months of 2009 than in 2008. Argyle Corrections continued to see its costs of revenues impacted by cost overruns associated with completing several existing projects, including a single ongoing project that had cost overruns of approximately \$4.3 million (of which \$0.9 million was recognized in the first quarter) through March 31, 2009. While all quantifiable jobs costs are included in determining our cost of revenues as they are identified by management, we expect that as the existing projects with cost overruns near completion, Argyle Corrections will likely continue to incur additional labor and equipment costs to ensure timely

completion in accordance with the project specifications. Additionally, we did not have a system in place at MCS-Detention that prevented overselling to potential customers based on our capacity to perform their work. In order to meet customer expectations, excessive overtime, unreimbursed project costs and additional manpower was required to meet tight delivery deadlines, which added unexpected costs to certain projects.

**Table of Contents****Gross Margin**

For the three months ended March 31, 2009, we generated gross profit of \$6.7 million, a \$253,000 increase over our gross profit of \$6.4 million for the corresponding period in 2008. Our gross profit percentage for the three months ended March 31, 2009 increased to 21.0% from 17.0% for the corresponding period in 2008. However, as discussed previously, our gross margins in the first quarter of 2008 included \$1.3 million of amortization expense compared with only \$110,000 in the first quarter of 2009. Excluding amortization, our gross margin percentage improved by 1% from the first quarter of 2008 to the first quarter of 2009. We have continued to experience gross margin erosion as a result of cost overruns on existing projects, however the impact of such cost overruns on our margins is decreasing as we expected. Additionally, we believe that our gross margin percentage should improve in subsequent quarters of 2009 as overrun jobs are completed and due to the implementation of operational controls on newer jobs. We believe the early financial results from projects which began under the supervision of new management indicate that effect of management oversight and our new operational controls have been successful in enabling us to achieve our targeted gross margin percentage on such projects.

**Operating Expenses**

Operating expenses decreased to \$5.9 million for the three months ended March 31, 2009, compared to \$6.8 million for the corresponding period in 2008. Absent non-cash charges, operating expenses typically consist of salaries and benefits for selling and administrative personnel, including human resources, executive, finance and legal. These expenses also include bad debt expenses, fees for professional services and other administrative expenses, as well as amortization of intangible assets. To reduce operating expenses, we have implemented cost reduction initiatives to reduce overhead and discretionary spending. As a result, general and administrative expenses and professional fees have been reduced to \$1.2 million from \$1.6 million for the three months ended March 31, 2009 and 2008. In addition, we have entered into a new arrangement with regard to our offices in New York, which is expected to additionally reduce expenses in the future.

We had \$145,000 in non-cash compensation expenses resulting from SFAS 123(R) related to restricted stock grants to our officers and directors and employee stock options. Such amount was included in the operating expenses for the quarter ended March 31, 2009, compared to \$0.6 million for the same period in 2008. The amortization of customer base and software is included in operating expenses and primarily relates to the acquisition of ISI on July 31, 2007 and Com-Tec, PDI, and Fire Quest during the quarter ended March 31, 2008.

**Other Income / Expense**

Interest expense represents interest on our line of credit, unsecured subordinated debt and notes issued during January 2008 in connection with the acquisition of Com-Tec, PDI, and Fire Quest. Total other income/expense for the three months ended March 31, 2009 was \$0.9 million, compared to expense of \$0.8 million for the corresponding period in 2008. Interest income for the three months ended March 31, 2009 mainly represents interest earned on the excess cash from the net proceeds of our preferred stock offering.

**Net Income / (Loss)**

For the three months ended March 31, 2009, we had net loss of \$231,000, compared to net loss of \$0.7 million for the corresponding period in 2008.

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

EBITDA decreased by \$153,000 to \$1.7 million in the three months ended March 31, 2009, compared to \$1.8 million in the corresponding period in 2008. The EBITDA Margin increased to 5.3% from 4.9% in the corresponding period in 2008. The March 31, 2009 EBITDA includes \$145,000 in Non-Cash Compensation Expense related to restricted stock grants and employee stock options for that period compared to \$0.6 million for the same period in 2008.

**Liquidity and Capital Resources**

Our primary liquidity needs are for financing working capital (including premiums, fees and letters of credit incurred in connection with bid and performance bonds), the purchase of materials for projects and the purchase of vehicles and related equipment. The nature of our business and operations as a security solutions provider causes cash flow from operations to be highly volatile. Historically, we financed our working capital requirements through a combination of internally generated cash, utilizing our line-of-credit facilities and through the sale of equity. Argyle's large security contracts can produce or consume cash. The production or consumption of cash is dependent on factors

inherent to the construction industry, including billing and payment terms of the contracts.

Following the closing of a new loan facility on October 3, 2008 and subsequent amendment on January 8, 2009, we had in place an \$18.6 million credit facility, whereby ISI is the borrower, to allow it to manage its working capital and project bonding requirements, subject to borrowing capacity based on certain financial covenants.

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Net cash resulting from operating activities for the three months ended March 31, 2009 amounted to \$3.0 compared to net cash (used in) operations of (\$2.9) million for the same period in 2008. The \$6.0 million improvement in cash flow from operating activities for the three months ended 2009 compared to 2008 was attributable to a \$0.5 million lower net loss and \$5.2 million in positive cash flow relating to working capital accounts such as collection of outstanding accounts receivable and management of accounts payable that resulted from improved management of collections and disbursements.

Net cash (used in) investing activities for the three months ended March 31, 2009 amounted to (\$291,000) compared to (\$6.3) million for the same period in 2008. The reduction in investing activities was attributed to acquisition related activities in the first quarter of 2008 which amounted to (\$5.5) million versus \$0 for the same period in 2009 and a \$490,000 reduction in purchases of property and equipment from first quarter of 2009 versus the same period in 2008. Net cash (used in) financing activities was (\$4.5) million during the three months ended March 31, 2009 compared to net cash provided by financing activities of \$8.1 million for the same period in 2008. The \$12.6 net increase of cash (used in) financing activities was largely attributable to net reduction of \$7.6 million of senior and subordinated debt, \$5.1 million of subordinated debt originated in the first quarter 2008 whereas we had none in 2009, \$2.5 million increase in restricted cash and \$2.7 of net proceeds from the sale of newly created preferred stock in the first quarter of 2009.

At March 31, 2009, we had current assets of \$57.0 million and current liabilities of \$29.3 million, resulting in a working capital surplus of approximately \$27.7 million, compared to a surplus of \$22.6 million at December 31, 2008. As of March 31, 2009, we had \$14.4 million in cash and cash equivalents, including \$5.0 million of restricted cash which is invested in a certificate of deposit earning interest of 2.5% per year and \$4.9 million of cash which is deposited in Certificate of Deposit Account Registry Service (CDARS) earning interest at a variable rate of return. The remaining \$4.5 million is deposited in several non-interest bearing operating bank accounts. The Company believes that it has enough cash available and expects to have enough income from operations to operate for at least the next 12 months.

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

Net proceeds from the sale of our units, after deducting certain offering expenses of approximately \$2.4 million (including underwriting discounts of approximately \$1.8 million) were approximately \$28.2 million. Approximately \$27.3 million of the proceeds from our Public Offering and the Private Placement, each occurring prior to the acquisition of ISI, were placed in a trust account for our benefit. Except for \$0.6 million in interest that was earned on the funds contained in the trust account and that was released to Argyle to be used as working capital, and the amounts released to Argyle for the payment of taxes, Argyle was not able to access the amounts held in the trust until we consummated the business combination with ISI.

On April 16, 2007, our officers and directors, an affiliate of Bob Marbut, our Chief Executive Officer, and certain of our consultants, pursuant to a note and warrant acquisition agreement, loaned Argyle an aggregate of \$300,000 and in exchange received promissory notes in the aggregate principal amount of \$300,000 and warrants to purchase an aggregate of up to 37,500 shares of common stock at an exercise price of \$5.50 per share. The promissory notes were repaid in full, plus accrued interest, in August 2007.

In April 2008, we completed a private placement of 18,750 shares of Series A Convertible Preferred Stock (convertible initially into 1,875,000 shares of common stock) to accredited investors and received gross proceeds of \$15.0 million. Rodman & Renshaw, LLC, a wholly owned subsidiary of Rodman & Renshaw Capital Group, Inc., served as the exclusive placement agent for the offering and received \$900,000 and 112,500 warrants to purchase an aggregate of up to 112,500 shares of Argyle's common stock; exercisable at \$8.00 per share, as a placement fee. In January 2009, we completed a private placement of 27,273 shares of Series B Voting Convertible Preferred Stock (convertible initially into 2,727,300 shares of common stock) to accredited investors and received gross proceeds of

\$3,000,030.

**Long-Term Debt**

Notes payable and Long-Term Debt consist of the following (in thousands):

<b>Collateral</b>	<b>March 31, 2009</b>	<b>December 31, 2008</b>
Notes payable:		
Vehicles and equipment	\$ 377	\$ 418
Unsecured debt related party	11,508	11,393
Unsecured convertible debt stockholders		1,925
Seller notes	5,533	6,106
Line of credit and senior term debt	9,000	12,951
	\$ 26,418	\$ 32,793
Less current maturities	3,807	3,235
Long term debt	\$ 22,611	\$ 29,558

**Table of Contents*****Vehicles and Equipment***

Amounts attributed to vehicles and equipment in the above table include notes in favor of The Frost National Bank related to vehicles and various equipment lines. Vehicle and equipment notes are staggered with regard to their maturities, each amortizing over 36 – 48 month periods. Interest rates on the individual notes range from prime plus 1.0% to a fixed rate of 10.0%. The weighted average interest rate for these borrowings was 8.9% and 9.4% at March 31, 2009 and March 31, 2008, respectively. Argyle has agreed to guarantee the obligations of ISI under the notes up to \$1 million.

***Unsecured Debt – Related Parties***

On January 2, 2008 an additional \$5.0 million in unsecured debt was funded to ISI by the same related party for which \$6.0 million was outstanding at December 31, 2007. All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreements contain prepayment options with prepayment penalties. Interest on the additional \$5.0 million of debt accrues at 11.58% per annum and is payable quarterly in arrears, deferred interest at the rate of 8.42% per annum, and default interest of an additional 2.0% per annum. The interest rate on all outstanding notes will increase by 4.0% if the outstanding notes are not repaid by September 30, 2010. The total debt of \$11.0 million plus accrued and unpaid interest is due and payable in one single payment on January 31, 2011. Argyle has agreed to guarantee the payment of the outstanding unsecured debt. There are both financial and restrictive covenants associated with the note agreements. As of March 31, 2009, ISI was in compliance or had received a waiver of non-compliance with all covenants. ISI expects to be in compliance with the modified covenants for the next year. On September 30, 2008, Argyle provided an unsecured, subordinated loan of \$2 million to ISI. The term of the loan was one month with the payment of all outstanding principal and accrued and unpaid interest due on October 31, 2008. The rate of interest was 6.0% per annum. The loan was repaid in full on October 3, 2008.

On October 28, 2008, the Board approved Argyle's providing guarantees to ISI and its subsidiaries as an alternative to bonding, in an aggregate amount of up to \$15.0 million, in order to allow us the ability to bid projects without obtaining bonding.

***Unsecured Convertible Debt – Stockholders***

In April 2007, our officers and directors, an affiliate of our Executive Chairman and Chief Executive Officer, and certain of our consultants, pursuant to a note and warrant acquisition agreement, loaned us an aggregate of \$300,000 and, in exchange, received promissory notes in the aggregate principal amount of \$300,000 and warrants to purchase an aggregate of up to 37,500 shares of common stock. The warrants are exercisable at \$5.50 per share of common stock and expire on January 24, 2011. The warrants also may be exercised on a net-share basis by the holders of the warrants. We have estimated, based upon a Black-Scholes model, that the fair value of the warrants on the date of issue was approximately \$2.48 per warrant (a total value of approximately \$93,000, using an expected life of two years, volatility of 2.39% and a risk-free rate of 5.0%). However, because the warrants have a limited trading history, the volatility assumption was based on information then available to management. The promissory notes had an interest at a rate of 4.0% per year and were repayable 30 days after the consummation of a business combination. The notes and the associated accrued interest were paid in full in August 2007.

As part of the merger consideration paid to acquire ISI, we issued unsecured convertible debt to the stockholders of ISI in the amount of \$1.9 million, at a rate of interest of 5.0% per annum, paid semiannually. The notes were able to be converted in whole or in part into shares of the Company's common stock at the election of the note holder at a share price of \$10.00 any time after January 1, 2008 or redeemed at the same price by the Company after January 1, 2009. On January 12, 2009, the notes were redeemed in full by the Company at \$10.00 per share for an aggregate of 192,763 shares of common stock.

***Seller Notes***

In connection with the PDI acquisition, ISI issued convertible promissory notes (the PDI Promissory Notes) in the aggregate principal amount of \$3.0 million. The aggregate principal amount of the PDI Promissory Notes may be reduced, depending on the occurrence of certain events described in the Asset Purchase Agreement. The payment of the PDI Promissory Notes is guaranteed by and secured by the assets of ISI and its subsidiaries, and they bear interest at 6.0% paid quarterly through December 2009. Argyle provided a guaranty of payment and performance of ISI's obligations under the PDI Promissory Notes and has been paying interest payments due on the PDI Promissory Notes

since December 2008, as a result of a payment blockage by ISI senior debtholder prohibiting ISI from making any payments on the notes. After December 2009, principal and interest payments of \$133,000 are due monthly with final payment occurring on December 31, 2011. From June 1, 2009 through November 15, 2009, we have the option to (i) convert \$500,000 of the outstanding principal into common stock of Argyle based on 95.0% of the closing price of the common stock for a 20-day trading period preceding notice of the Company's intent to convert; or (ii) extend the \$500,000 principal due in 2010 to January 3, 2011 for an additional payment of \$15,000 plus accrued interest. The aforementioned options to convert or extend the PDI Promissory Notes resulted in the creation of compound embedded derivatives for which the Company has performed valuations at the end of each fiscal quarter. The Company will mark-to-market the derivatives, for which any changes in fair value will be recognized in the statement of operations, in all the subsequent quarters until they are exercised or have expired. The valuation of these derivatives held a value of \$26,000 as of March 31, 2009. In April 2009, ISI and each of the holders of the PDI Promissory Notes entered into an amendment to correct a ministerial error whereby the maturity date as defined in each PDI Promissory Note did not accurately correspond with the business understanding of the parties and the payment being made under the repayment schedule. This ministerial error does not have any impact on our prior financial reports.



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In connection with the Com-Tec acquisition, ISI issued a secured subordinated promissory note in the aggregate principal amount of \$3.5 million (the Com-Tec Promissory Note). The Com-Tec Promissory Note is guaranteed by and secured by the assets of ISI and its subsidiaries, bears interest at 7.0% per year and have a maturity date of April 1, 2011. Argyle provided a guaranty of payment and performance of ISI's obligations under the Com-Tec Promissory Note and has been paying interest payments due on the Com-Tec Promissory Note since December 2008, as a result of a payment blockage by ISI senior debtholder prohibiting ISI from making any payments on the notes. Interest only payments were made for each three-month period beginning on May 2008 and August 2008; a single principal payment of \$100,000 was due and paid on December 15, 2008; and level principal and interest payments in the cumulative amount of \$128,058 became due monthly beginning on August 1, 2008 and continuing monthly thereafter on the first day of each month for consecutive months through December 2008; then level principal and interest payments in the cumulative amount of \$123,748 became due monthly beginning on January 1, 2009, and continuing monthly thereafter on the first day of each month through December 2009, then for 25 consecutive months until the maturity date. On March 2, 2009, the principal of the Com-Tec Promissory Note was reduced to \$3,491,290.80 as a result of adjustments made because of uncollected accounts receivable. Collectively, the PDI Promissory Notes and the Com-Tec Promissory Note are hereinafter referred to as the Seller Notes.

**Senior Secured Credit Facility**

At March 31, 2009, ISI had a line of credit facility for (i) a secured revolving line of credit in the maximum amount of \$10.0 million with a \$5.0 million sublimit for the issuance of letters of credit, (ii) a secured revolving line of credit in the maximum amount of \$1.1 million, to be used solely for the issuance of letters of credit and (iii) a term loan in the original amount of \$10.0 million (collectively, the Loans). The Loans mature on October 2, 2011. Upon closing, the proceeds were used to pay off existing indebtedness, with the remaining availability to be used for working capital and other general corporate purposes. Argyle agreed to provide a guaranty of the Loans up to \$18.1 million until the completion of an audit for the fiscal year ended 2009 (the Guaranty Agreement); provided, however that the Guaranty Agreement will terminate on the earlier of (a) the payment in full of all obligations under the Loan Agreement or (b) at the time the Bank determines in its sole judgment that ISI's financial statements issued pursuant to the Loan Agreement for the fiscal year ended December 31, 2009 establish that ISI is in compliance with the amended financial covenants of the Loan Agreement. The line of credit that is used solely for letters of credit was decreased from \$5.0 million to \$1.0 million, and the promissory note evidencing the line of credit was amended and restated to reflect the principal amount reduction. The Loans will continue to be secured by liens on and security interests in the personal property of ISI and guaranteed by the subsidiaries of ISI.

The interest rates of the Loans are, at ISI's option from time to time, (i) a floating per annum rate of interest equal to the prime rate plus the Applicable Margin, or (ii) the LIBOR Rate plus the Applicable Margin. The Applicable Margin means the rate per annum added to the prime rate and LIBOR as determined by the ratio of total debt to EBITDA of ISI and its subsidiaries for the prior fiscal quarter. The weighted average interest rate for these borrowings was 6.0% and 5.9% at March 31, 2009 and March 31, 2008, respectively.

In connection with the Loans, the holders of each Seller Note agreed to be subordinated to the lender with respect to payment and perfection. In addition, the maturity dates of each Seller Note was effectively extended to be no earlier than the date on which all of the outstanding obligations of ISI to repay the outstanding principal and accrued and unpaid interest relating to the Loans are satisfied.

The agreement contains both financial and restrictive covenants, including a restriction on the payment of dividends by ISI. Under the terms of the credit facility, as of March 31, 2009, ISI is indebted for \$7.0 million in term debt and \$2.0 million through the line of credit. As of March 31, 2009, ISI was in compliance with all covenants.

Aggregate maturities required on all debt at March 31, 2009 are as follows (in thousands):

**Year Ending December 31:**

2009 (remaining nine months)	\$	2,585
2010		4,959
2011		18,738

2012	66
2013	70
Thereafter	

\$ 26,418

**Table of Contents*****Interest Rate Risk Management***

We use derivative instruments to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with changes in the London Inter-bank Offer Rate ( LIBOR ) applicable to its variable rate debt discussed above. We utilize interest rate swap agreement to convert a portion of the variable rate debt to a fixed rate obligation. We account for the interest rate swaps in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

During the fourth quarter of 2008, we entered into a U.S. dollar amortizing interest rate swap agreement, which became effective on December 1, 2008, with a notional amount starting at \$10.0 million. The notional amount of the swap is set to decrease periodically as set forth in the swap agreement. The hedging agreement duration matches the term length of the loan. The Company presents the fair value of the interest rate swap agreement at the end of the period in other long term liabilities, as applicable, on its consolidated balance sheet.

At March 31, 2009, the interest rate swap (liability) had a fair value (net of taxes) of approximately \$117,214, compared to \$115,997 at December 31, 2008. During the quarter ended March 31, 2009, we recognized interest expense from hedging activities relating to interest rate swaps of \$26,392. There were no ineffective amounts recognized during the quarter ended March 31, 2009, and we do not expect the hedging activities to result in an ineffectiveness being recognized in the earnings.

At March 31, 2009, accumulated other comprehensive income included a deferred pre-tax net loss of \$189,973, compared to \$188,001 at December 31, 2008 related to the interest rate swap. For the quarter and year ended March 31, 2009 and December 31, 2008, we did not reclassify any pre-tax expense into interest expense from accumulated other comprehensive income as adjustments to interest payments on variable rate debt.

***Commitments***

We lease office space and equipment under operating leases expiring through 2012. The corporate office lease space in San Antonio, TX expired as of July 31, 2007, and we operated under a month-to-month lease arrangement until it was renewed in January 2008. The new lease expanded the space from approximately 2,500 square feet to 5,500 square feet for a total expense in 2008 of \$122,000 and \$32,000 for the first quarter of 2009. This lease expires in January 2013.

As part of the acquisition of PDI on January 4, 2008, ISI assumed PDI's existing leases in California and Arizona. On September 5, 2008, ISI entered into a lease relating to approximately 29,709 square feet of property located at 577 and 583 North Batavia Street, Orange, California. The term of the new lease is for two years commencing September 1, 2008 and ending August 31, 2010. The aggregate monthly base rent is \$16,934. In connection with the lease, on September 5, 2008, Argyle entered into a guaranty pursuant to which Argyle has agreed to guarantee the payment and performance obligations of ISI under the lease. The PDI lease in Arizona is a four year lease. The three facilities occupy a total of 55,709 square feet (26,000 square foot facility in Arizona and the 29,709 square foot facilities in California) with aggregate monthly payments of \$32,934.

As part of the Com-Tec acquisition that occurred at January 31, 2008, we signed a new lease for the existing facility. The Com-Tec lease is a five year lease, for the 33,000 square foot facility, with aggregate monthly payments of \$14,000 beginning in year three with the total rent expense being recognized on a straight-line basis over the life of the lease.

Rental expense was \$342,000 and \$196,000 for the quarter ended March 31, 2009 and 2008, respectively.

In August 2007, we entered into a letter of credit facility with a financial institution. The letter of credit may not exceed \$500,000. The facility requires a 1.0% annual commitment fee on the unused portion of the letter of credit facility and is paid quarterly.

In May 2008, we entered into a letter of credit facility with a financial institution, secured by \$2.5 million of restricted cash. The letter of credit may not exceed \$2.5 million. The facility does not have a fee on the unused portion of the letter of credit facility.

In February 2009, Argyle entered into a letter of credit facility with the PrivateBank, collateralized by \$2.5 million in restricted cash. The letter of credit may not exceed \$2.5 million. The facility does not have a fee on the unused portion of the letter of credit facility.

**Off Balance Sheet Arrangements**

Argyle does not have any off-balance sheet arrangements.

**Table of Contents****Contractual Obligations**

Aggregate amounts at March 31, 2009 are as follows (in thousands):

	<b>Total</b>	<b>&lt; 1 Year</b>	<b>1 &lt; 3 Years</b>	<b>3 &lt; 5 Years</b>	<b>&gt; 5 Years</b>
Principal on Long Term Debt Obligations	\$ 26,418	\$ 3,807	\$ 22,491	\$ 120	\$
Capital Lease Obligations	5,248	516	1,024	986	2,722
Operating Lease Obligations	3,502	923	1,671	835	73
Interest on Long Term Debt Obligations	9,542	2,616	4,710	2,216	
<b>Total</b>	<b>\$ 44,710</b>	<b>\$ 7,862</b>	<b>\$ 29,896</b>	<b>\$ 4,157</b>	<b>\$ 2,795</b>

**Subsequent Events**

On April 24, 2009, ISI and each of the holders of the PDI Promissory Notes entered into an amendment to correct a ministerial error whereby the maturity date as defined in each PDI Promissory Note did not accurately correspond with the business understanding of the parties and the payments being made under the repayment schedule. This ministerial error does not have any impact on our prior financial reports. Copies of the Allonges to the PDI Promissory Notes (collectively, the Allonges ) are filed as Exhibit 10.1 and 10.2 of this Quarterly Report.

On April 30, 2009, Argyle entered into a Lease Agreement (the NY Lease ) relating to approximately 1,350 square feet of property located at 40 West 37<sup>th</sup> Street, New York, NY (the NY Office ). The term of the NY Lease is for one year commencing May 11, 2009 and ending May 31, 2010. The monthly base rent is \$3,656. A copy of the NY Lease is filed as Exhibit 10.3 hereto. In connection with entering into the NY Lease, Argyle terminated its existing cost-sharing arrangement with Sec-Tec relating to the office space in New York, NY whereby Argyle had paid Sec-Tec an aggregate of \$185,000 per year. Sec-Tec has agreed to permit Argyle to use certain of Sec-Tec's furniture and equipment in the NY Office. In addition, in consideration for terminating the cost-sharing arrangement, Argyle will permit Sec-Tec to utilize one telephone line and, if available and needed, a portion of the NY Office.

The description of the Allonges and NY Lease herein does not purport to be complete and is qualified in its entirety by reference to the full text of each of the exhibits filed herewith and incorporated by this reference.

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**PART II OTHER INFORMATION**

**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Allonge to Guaranteed Convertible Promissory Note (M) dated April 24, 2009 by and between ISI Detention Contracting Group, Inc. and Peterson Detention Inc.*
10.2	Allonge to Guaranteed Convertible Promissory Note (L) dated April 24, 2009 by and between ISI Detention Contracting Group, Inc. and Peterson Detention Inc.*
10.3	Lease Agreement dated April 30, 2009 between Park Ridge International, Inc. and Argyle Security, Inc.*
31.1	Certification of the Chief Executive Officer (Principal Executive Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended, filed herewith.
31.2	Certification of the President and Chief Operating Officer (Principal Executive Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended, filed herewith.
31.3	Certification of the Executive Vice President and Chief Financial Officer (Principal Financial Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended, filed herewith.
31.4	Certification of the Vice President and Corporate Controller (Principal Accounting Officer) pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended, filed herewith.
32	Certification of the Chief Executive Officer, President and Chief Operating Officer, Executive Vice President and Chief Financial Officer and Vice President and Corporate Controller pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

\* Previously furnished.

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**SIGNATURES**

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

ARGYLE SECURITY, INC

May 19, 2009

By: /s/ Bob Marbut  
Bob Marbut  
Chief Executive Officer  
(Principal Executive Officer)

May 19, 2009

By: /s/ Sam Youngblood  
Sam Youngblood  
President and Chief Operating Officer  
(Principal Executive Officer)

May 19, 2009

By: /s/ Donald F. Neville  
Donald F. Neville  
Executive Vice President and Chief Financial  
Officer  
(Principal Financial Officer)

May 19, 2009

By: /s/ Dean A. Dresser  
Dean A. Dresser  
Vice President and Corporate Controller  
(Principal Accounting Officer)

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**EXHIBIT INDEX**

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