

ARGYLE SECURITY, INC.

Form 10-Q

August 13, 2009

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 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 * The registrant has not yet been phased into the Interactive Data requirement.

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 6,277,105, shares of the Registrant's common stock issued and outstanding as of August 12, 2009.

Argyle Security, Inc. Index to Form 10-Q

<u>Part I. Financial Information</u>	1
<u>Item 1. Financial Statements</u>	1
<u>Consolidated Balance Sheets</u>	1
<u>Consolidated Statements of Operations</u>	2
<u>Consolidated Statement of Stockholders' Equity</u>	4
<u>Consolidated Statement of Cash Flows</u>	5
<u>Notes to Unaudited Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	51
<u>Item 4T. Controls and Procedures</u>	51
<u>Part II. Other Information</u>	52
<u>Item 1. Legal Proceedings</u>	52
<u>Item 1A. Risk Factors</u>	52
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 3. Defaults Upon Senior Securities</u>	53
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	53
<u>Item 5. Other Information</u>	54
<u>Item 6. Exhibits</u>	54
<u>SIGNATURES</u>	55
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 31.3</u>	
<u>Exhibit 31.4</u>	
<u>Exhibit 32</u>	

Table of Contents

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

	June 30, 2009 unaudited	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 10,180	\$ 11,142
Restricted cash	5,000	2,500
Receivables:		
Contract net of allowance for doubtful accounts of \$735 and \$777 at June 30, 2009 December 31, 2008, respectively	20,559	28,815
Contract receivables related party	2,651	4,685
Other receivables	37	335
Costs and estimated earnings in excess of billings on incomplete contracts	10,346	6,475
Intangible assets		184
Refundable income taxes		168
Inventory	1,505	2,146
Other current assets	196	385
Deferred income taxes, net	405	898
Total current assets	50,879	57,733
Property and equipment, net	8,511	9,033
Goodwill	2,844	2,844
Intangible assets	11,430	12,111
Deposits, deferred transaction costs, and other assets	391	591
Total other assets	23,176	24,579
Total assets	\$ 74,055	\$ 82,312
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 12,636	\$ 15,799
Accounts payable related party		173
Billings in excess of costs and estimated earnings on incomplete contracts	5,365	7,633
Interest payable to stockholders		49
Current portion of capitalized lease obligations	249	239
Current portion of long-term debt	4,185	3,235
Total current liabilities	22,435	27,128

Edgar Filing: ARGYLE SECURITY, INC. - Form 10-Q

Long-Term Liabilities:

Deferred income taxes	1,346	1,577
Long-term debt less current portion	21,493	29,558
Derivative, deferred rent and other long term liabilities (including dividends)	947	635
Long-term capitalized lease obligations less current portion	3,262	3,389
Total long-term liabilities	27,048	35,159
Total liabilities	49,483	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 June 30, 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 6,277,105 shares at June 30, 2009 and 5,969,342 shares at December 31, 2008		
Additional paid in capital	55,656	50,925
Accumulated other comprehensive income (loss)	(96)	(116)
Accumulated earnings (deficit)	(30,989)	(30,785)
Total stockholders' equity	24,572	20,025
Total liabilities and stockholders' equity	\$ 74,055	\$ 82,312

See notes to unaudited consolidated financial statements

Table of Contents

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

(in thousands except share data)

	Three Months Ended	
	June 30,	June 30,
	2009	2008
Revenues:		
Contract revenues	\$ 25,390	\$ 26,572
Contract revenues related party		5,282
Manufacturing revenues	1,868	1,923
Service and other revenues	3,129	2,729
Total revenues	30,387	36,506
Cost of revenues:		
Contract costs	20,085	26,285
Manufacturing costs	1,122	1,158
Service and other costs, including \$74 and \$1,276 of amortization of intangibles in 2009 and 2008, respectively	2,199	2,999
Total cost of revenues	23,406	30,442
Gross profit	6,981	6,064
Operating expenses:		
Salaries and related expense, including stock-based compensation of (\$29) and \$191 in 2009 and 2008, respectively	2,961	3,410
Professional fees and outside services	546	638
General and administrative expenses	1,287	1,671
Depreciation	436	598
Amortization of intangible assets	340	426
Total operating expenses	5,570	6,743
Operating income (loss)	1,411	(679)
Other income (expense):		
Interest income	6	52
Interest expense	(820)	(854)
Total other income (expense)	(814)	(802)
Income (loss) before provision for income taxes	597	(1,481)
(Benefit) Provision for income taxes	282	(461)
Net income (loss)	315	(1,020)
Dividends on redeemable preferred stock	(145)	(86)
Net income (loss) allocable to holders of common stock	\$ 170	\$ (1,106)

Weighted-average number of shares of common stock outstanding		
Basic	6,038,772	5,799,342
Diluted	6,270,292	5,799,342
Net income (loss) per share allocable to holders of common stock		
Basic	\$ 0.02	\$ (0.19)
Diluted	\$ 0.02	\$ (0.19)

See notes to unaudited consolidated financial statements

Table of Contents

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

(in thousands except share data)

	Six Months Ended	
	June 30, 2009	June 30, 2008
Revenues:		
Contract revenues	\$ 50,716	\$ 53,432
Contract revenues related party	860	12,225
Manufacturing revenues	3,769	3,441
Service and other revenues	6,786	5,005
Total revenues	62,131	74,103
Cost of revenues:		
Contract costs	41,417	53,627
Manufacturing costs	2,380	1,848
Service and other costs, including \$184 and \$2,529 of amortization of intangibles in 2009 and 2008, respectively	4,696	6,159
Total cost of revenues	48,493	61,634
Gross profit	13,638	12,469
Operating expenses:		
Salaries and related expense, including stock-based compensation of \$116 and \$749 in 2009 and 2008, respectively	5,971	6,779
Professional fees and outside services	1,426	1,583
General and administrative expenses	2,513	3,259
Depreciation	861	1,057
Amortization of intangible assets	681	847
Total operating expenses	11,452	13,525
Operating income (loss)	2,186	(1,056)
Other income (expense):		
Interest income	31	78
Interest expense	(1,703)	(1,653)
Total other income (expense)	(1,672)	(1,575)
Income (loss) before provision for income taxes	514	(2,631)
(Benefit) Provision for income taxes	430	(877)
Net income (loss)	84	(1,754)
Dividends on redeemable preferred stock	(288)	(86)
Net income (loss) allocable to holders of common stock	\$ (204)	\$ (1,840)

Weighted-average number of shares of common stock outstanding		
Basic	6,029,187	5,795,221
Diluted	6,029,187	5,795,221
Net income (loss) per share allocable to holders of common stock		
Basic	\$ (0.03)	\$ (0.32)
Diluted	\$ (0.03)	\$ (0.32)

See notes to unaudited consolidated financial statements

Table of Contents

ARGYLE SECURITY, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
DECEMBER 31, 2008 THROUGH JUNE 30, 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				
Balance at December 31, 2008	5,969,342	\$ 1	18,750	\$ 0	\$ 50,925	\$ (116)	\$ (30,785)	\$ 20,025
Net income (loss)							84	84
Deferred gain / (loss) on hedging activities, net of taxes						20		20
ISI seller note conversion	192,763				1,928			1,928
Stock-based compensation	145,000				116			116
Forfeiture of stock-based compensation	(30,000)							
Issuance of preferred stock			27,273	0	2,687			2,687
Dividends on preferred stock							(288)	(288)
Balance at June 30, 2009	6,277,105	\$ 1	46,023	\$ 0	\$ 55,656	\$ (96)	\$ (30,989)	\$ 24,572

See notes to unaudited consolidated financial statements

Table of Contents

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

	Six Months Ended	
	June 30, 2009	June 30, 2008
Cash flows from operating activities:		
Net income (loss)	\$ 84	\$ (1,754)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities		
Stock-based compensation	116	749
Amortization	865	3,376
Depreciation	944	1,114
Gain (loss) on disposal of asset	8	
Deferred interest on Merit debt	233	
Decrease (increase) in contract receivables	8,256	(10,210)
Decrease (increase) in related party contract receivables	2,034	43
Decrease (increase) in related party receivables	298	9
Decrease (increase) in costs and estimated earnings in excess of billings	(3,871)	1,687
Decrease (increase) in other assets	781	(76)
Increase (decrease) in accounts payable and accrued expenses	(3,028)	(660)
Increase (decrease) in other long-term liabilities	41	64
Increase (decrease) in deferred income taxes and refundable taxes	430	(963)
Increase (decrease) in billings in excess of costs and estimated earnings	(2,268)	4,022
Net cash provided by (used in) operating activities	\$ 4,923	\$ (2,599)
Cash flows from investing activities:		
Acquisition of PDI, Com-Tec, and Fire Quest in 2008, net of cash acquired		(5,264)
Purchase of property and equipment	(431)	(1,679)
Transaction costs		(329)
Net cash provided by (used in) investing activities	\$ (431)	\$ (7,272)
Cash flows from financing activities:		
Issuance of preferred stock	3,000	15,000
Restricted cash	(2,500)	(2,505)
Offering costs and financing costs	(414)	(1,452)
Repayment on borrowings	(12,918)	(23,097)
Proceeds from borrowings	7,495	27,271
Proceeds from notes payable		5,000
Payments on capital lease obligations	(117)	(64)
Net cash provided by (used in) financing activities	\$ (5,454)	\$ 20,153
Net increase (decrease) in cash and cash equivalents	\$ (962)	\$ 10,282

Edgar Filing: ARGYLE SECURITY, INC. - Form 10-Q

Cash and cash equivalents at beginning of year	11,142	3,556
Cash and cash equivalents at end of period	\$ 10,180	\$ 13,838

See notes to unaudited consolidated financial statements

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 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 its 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 June 30, 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 1 Basis of Presentation (continued)

On June 15, 2009, the Company and MML Capital Partners LLC, in its capacity as advisor to, and on behalf of, Mezzanine Management Fund IV A L.P. and Mezzanine Management Fund Coinvest A L.P. (collectively MML) entered into a non-binding letter of intent (the LOI) to enter into a transaction whereby an entity controlled by MML (the Acquiring Company) would merge its wholly-owned subsidiary into the Company, resulting in the Company becoming a wholly-owned subsidiary of the Acquiring Company. Pursuant to the merger, existing stockholders and unitholders of the Company would receive \$2.00 per share or unit, as applicable, in cash. It is anticipated that certain members of the Company s continuing management team and certain creditors may rollover their shares of Company common stock for common stock of the Acquiring Company based on the \$2 per share price.

The Company s Board of Directors (the Board) appointed a special committee (the Special Committee) composed solely of independent directors to consider the proposal and recommend it to the Board for approval. The special committee has engaged Houlihan Lokey, as its independent financial advisor, to assist it with its assessment of MML s offer.

The Company had received an original conditional offer from MML on May 19, 2009. Following negotiations the Special Committee recommended that the Board authorize the Company to enter into the LOI. Based on the recommendation of the Special Committee, the Board voted to approve the Company entering into the LOI. Pursuant to the LOI, MML was granted an exclusivity period expiring on the earlier of the execution of a definitive agreement or 45 days after June 15, 2009 (the Exclusivity Period) in which to complete its confirmatory due diligence and execute definitive documentation with the Company. Notwithstanding the expiration of the Exclusivity Period, the Company and MML continue to be engaged in non-binding negotiations involving a proposed transaction.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 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 and six months ended June 30, 2008.

The pro forma results of operations for the Company for the three and six months ended June 30, 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 and six months ended June 30, 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 and six months ended June 30, 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 pro forma statement of operations for the same period in 2008.

Pro Forma Consolidated Statement of Operations Data
(unaudited)

(in thousands except share data)

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2009	2008	2009	2008
Total revenues	30,387	36,506	62,131	75,821
Net income (loss) allocable to holders of common stock	\$ 170	\$ (1,106)	\$ (204)	\$ (1,855)
Weighted-average number of shares of common stock outstanding				
Basic	6,038,772	5,799,342	6,029,187	5,795,221
Diluted	6,270,292	5,799,342	6,029,187	5,795,221
Net income (loss) per share allocable to holders of common stock				
Basic	\$ 0.02	\$ (0.19)	\$ (0.03)	\$ (0.32)
Diluted	\$ 0.02	\$ (0.19)	\$ (0.03)	\$ (0.32)

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 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 letter of credit agreements.

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 (recovery) for the three months ended June 30, 2009 and 2008 was (\$4,000) and \$143,000, respectively, and for the six month ended June 30, 2009 and 2008 was \$44,000 and \$288,000, respectively, and is reflected in the general and administrative expenses in the unaudited 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

Construction Contracts (continued)

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

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

Service Sales

Service 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 \$75,000 and \$217,000 in shipping and handling costs which are reflected in the service and other costs in the Statement of Operations for the three and six months ended June 30, 2009.

Inventory

Inventory is valued at the lower of cost or market and consists of raw materials, work in process (WIP) and finished goods. 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 June 30, 2009 and December 31, 2008, the Company's inventory balance (net of reserves) was \$1.5 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

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.

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. There were no such events that occurred prior to July 1, 2009 and therefore the Company will perform the annual impairment assessment for the 3rd quarter financial statements.

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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

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 June 30, 2009, the warranty reserve was \$175,000 and is included in accounts payable and accrued expenses on the unaudited consolidated balance sheet.

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 and six months ended June 30, 2009, the Company collected \$215,000 and \$549,000, respectively and remitted \$244,000 and \$664,000, respectively, in taxes. Sales and use taxes are reflected in the general and administrative expenses on a net basis.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

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 previously included with service and other revenues and service and other cost of revenues.

Recently Issued Accounting Pronouncements

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140* (FAS 166). FAS 166 amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), removing the concept of a qualifying special-purpose entity and the exception from applying FASB Interpretation No. 46(R) (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)), to qualifying special-purpose entities. This statement is effective for both interim and annual periods as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, and its impact will vary with each future transfer of financial assets.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). FAS 167 amends FASB Interpretation No. 46(R) (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)), to require a company to perform an analysis to determine whether the company's variable interest or interests give it a controlling financial interest in a variable interest entity. This statement is effective for both interim and annual periods as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, and we are currently evaluating its impact on our financial position and results of operations.

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, *Subsequent Events* (FAS 165). FAS 165 establishes general standards of accounting for and disclosing events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement is effective for interim and annual periods ending after June 15, 2009, and the Company will perform subsequent events review through the date of each filing. The Company has disclosed all material subsequent events (see Note 16) that occurred between July 1, 2009 and through August 13, 2009 in this Form 10-Q.

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 June 15, 2009. These staff positions require enhanced disclosures on financial instruments and have increased quarterly disclosures but did not have an impact on our financial position and results of operations.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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 and six months ended June 30, 2009, the Company conducted regular reviews and evaluations for the cost estimates associated with all of the approximately 1,410 active contracts in the Company's Work-in-Process. Changes in cost estimates came as the result of 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 June 30, 2009) increased by a net \$1.8 million in quarter ended June 30, 2009. Of the aforementioned net estimated cost increases of \$1.8 million, 19 contracts with cost estimate changes of approximately \$100,000 or greater resulting in \$1.8 million or 98.4% of the total net increases. Ten of the total 19 of the contracts with changes greater than \$100,000 resulted in cost estimate increases totaling \$3.5 million while nine contracts had estimated cost decreases totaling \$1.7 million. Approximately 1,390 of the remaining contracts with variances of less than \$100,000 resulted in a net decrease in cost estimates of \$31,000 or 1.6% of the total net increases.

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 June 30, 2009, the Company did not have any loss contingencies requiring disclosures or accruals.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

Financial instruments that potentially expose the Company to concentrations of credit risk, as defined by SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, consist primarily of contract receivables. During the three and six months ended June 30, 2009, revenues from our top three customers (all from Argyle Corrections) represented 38.0% and 30.0% of total Company revenues, respectively. During the three and six months ended June 30, 2009, the Company had revenues from our top two customers (all from Argyle Corrections), which represented 32.1% and 25.8% of total Company revenues, respectively. These concentrations are up from the quarter ended March 31, 2009 and the year ended December 31, 2008, when the top three customers represented 29.4% and 27.0% of total Company revenues, respectively. See Related-Party Transactions footnote (see Note 13) for discussion of transactions with ISI*MCS, Ltd.

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.

As of June 30, 2009, the Company had granted 335,000 shares of restricted stock, of which 100,000 shares were vested.

As of the quarters ended June 30, 2009 and 2008 the shares used to calculate earnings per share are shown below.

	Three Months Ended June 30		Six Months Ended June 30,	
	2009	2008	2009	2008
Weighted average common shares outstanding basic	6,038,772	5,799,342	6,029,187	5,795,221
Effect of convertible securities	231,520			
Weighted average common shares outstanding diluted	6,270,292	5,799,342	6,029,187	5,795,221

As of June 30, 2009 there were 231,520 shares of restricted stock that were included in the earning per share calculation. Additionally, as of June 30, 2009 there were 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 4,602,300 common shares and these have been considered in the calculation of the earnings per share using the two-class method. There are no other participating securities.

A portion of the PDI Seller Notes (See Note 5) became convertible to common stock on June 1, 2009 at the election of the Company; however, the Company has decided not to elect to convert the aforementioned debt prior to November 1, 2009, the date on which such election expires. As a result, the dilutive impact of the shares from the PDI Seller Notes conversion have been excluded from the calculation of diluted earnings per share.

Note 3 Contract Receivables

Contract receivables consist of the following (in thousands):

	June 30, 2009	December 31, 2008
Completed contracts and contracts in progress (net of allowance)	\$ 15,460	\$ 24,494
Retainage	5,099	4,321
Completed contracts and contracts in progress related parties	1,568	2,938
Retainage related parties	1,083	1,747
Contract receivables	\$ 23,210	\$ 33,500

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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):

	Total June 30, 2009	Corrections June 30, 2009	Commercial June 30, 2009
Amended contract amount	\$ 300,705	\$ 241,415	\$ 59,290
Revenues recognized to date	254,539	204,848	49,691
Unearned contract amount backlog	\$ 46,166	\$ 36,567	\$ 9,599
Costs incurred to date	218,400	178,747	39,653
Estimated costs to complete	31,910	25,720	6,190
Estimated total cost	\$ 250,310	\$ 204,467	\$ 45,843
Billings to date	\$ 249,723	\$ 200,478	\$ 49,245
Costs and estimated earnings in excess of billings on incomplete contracts	\$ 10,346	\$ 8,187	\$ 2,159
Billing in excess of costs and estimated earnings on incomplete contracts	\$ 5,365	\$ 3,499	\$ 1,866
	Total December 31, 2008	Corrections December 31, 2008	Commercial December 31, 2008
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).

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 June 30, 2009 backlog from 14 letters of intent amounted to \$12.6 million. The Company also verifies that funding is in place on the contracts prior to inclusion in backlog.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 5 Long-Term Debt

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

	June 30, 2009		December 31, 2008	
	Book Value	Fair Value	Book Value	Fair Value
Collateral				
Notes payable:				
Vehicles and equipment	\$ 347	\$ 347	\$ 418	\$ 418
Unsecured debt related party	11,626	11,626	11,393	11,393
Unsecured convertible debt stockholders			1,925	1,925
Seller notes	5,205	5,205	6,106	6,106
Line of credit and senior term debt	8,500	8,500	12,951	12,951
	\$ 25,678	\$ 25,678	\$ 32,793	\$ 32,793
Less current maturities	4,185	4,185	3,235	3,235
Long term debt	\$ 21,493	\$ 21,493	\$ 29,558	\$ 29,558

Management has determined that the carrying value of the debt outstanding at June 30, 2009 approximates the fair value based on borrowing rates currently available to the Company for financing arrangements with similar terms and maturities.

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 6.1% and 9.4% at June 30, 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 June 30, 2009, ISI was in compliance with or received waivers of any default of all covenants (See Note 16 Subsequent Events relating to amendments and waivers on August 3, 2009). 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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 \$8,600 as of June 30, 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 .

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 5 Long-Term Debt (continued)

Senior Secured Credit Facility

At June 30, 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 5.7% and 5.9% at June 30, 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 June 30, 2009, ISI is indebted for \$6.5 million in term debt and \$2.0 million through the line of credit. As of June 30, 2009, ISI was in compliance with or received waivers of any default of all covenants (See Note 16 Subsequent Events relating to amendments and waivers on August 3, 2009).

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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 an 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 and was \$8.5 million at June 30, 2009. 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 unaudited consolidated balance sheet are as follows:

Balance Sheet Location	Fair Value	
	June 30, 2009	December 31, 2008
Derivatives designated as hedging instrument under FAS 133		
Derivative Liabilities:		
Interest Rate Contracts	Derivative, deferred rent and other long term liabilities (including dividends)	
	\$ 157,107	\$ 188,001

At June 30, 2009, the interest rate swap had a fair value (net of taxes) of approximately \$97,273. During the three and six months ended June 30, 2009, we recognized expense from hedging activities relating to interest rate swaps of \$30,713 and \$57,105, respectively. There were no ineffective amounts recognized during the period ended June 30, 2009, and we do not expect the hedging activities to result in an ineffectiveness being recognized in earnings.

At June 30, 2009, accumulated other comprehensive income included a deferred pre-tax net loss of \$157,107 related to the interest rate swap.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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 adopted the provisions of SFAS No. 157 for nonfinancial assets and liabilities. 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 June 30, 2009 and December 31, 2008:

Liability	Significant Other Observable Inputs (Level 2)	
	June 30, 2009	December 31, 2008
Interest Rate Swap (included in Deferred rent and other long term liabilities)	\$ 157,107	\$ 188,001

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 7 Commitments

We lease office space and equipment under operating leases expiring through 2013. 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.

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 37th 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 (excluding two weeks of free rent in May 2010).

Rental expense was \$316,000 and \$217,000 for the three months ended June 30, 2009 and 2008, respectively, and \$658,000 and \$540,000 for the six months ended June 30, 2009 and 2008.

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 a financial institution, 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 June 30, 2009, 4,485,046 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 145,000 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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. Currently 46,023 shares of preferred stock are issued and outstanding.

On April 22, 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 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

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 one officer voluntarily forfeited 30,000 shares of 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.

On June 1, 2009, the Company granted 10,000 unregistered shares of our common stock to one, newly elected, non-employee director. 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 June 30, 2009 was 335,000 shares of which 100,000 shares are vested leaving 180,000 to vest in December, 31 2009, 2010 and 2011 and 55,000 shares are vested seven (7) days after the Director is no longer serving on the Board.

During the three and six months ended June 30, 2009, the Company recognized (\$68,000) and \$46,000 in compensation expense, net of deferred tax (expense) benefit of (\$23,000) and \$16,000, respectively, related to the Company's issuance of restricted stock. As of June 30, 2009, there was \$272,000 of unrecognized compensation costs, net of estimated forfeitures, related to the Company's non-vested restricted stock.

Performance Unit Awards

On January 25, 2008 and August 25, 2008, the Company granted an aggregate of 55,000 and 5,000 performance unit awards, respectively, 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 determined by the Board of Directors are achieved.

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 determined by the Board of Directors are achieved. On February 1, 2009 two officers forfeited 25,000 and 55,000 performance unit awards, respectively, leaving 205,000 total performance unit awards outstanding.

No compensation expense was recognized for the three and six months ended June 30, 2009 for the performance unit awards.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 10 Stockholders Equity and Stock-Based Compensation (continued)
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 number of stock options outstanding as of June 30, 2009 was 510,000 of which 76,667 are exercisable leaving 433,333 to vest in December, 31 2009, 2010 and 2011.

During the three and six months ended June 30, 2009, the Company recognized \$39,000 and \$70,000, in compensation expense, net of tax benefit of \$13,000 and \$24,000, respectively related to the Company's stock options. As of June 30, 2009, there was \$121,000 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 \$282,000 and \$430,000 for the three months and six months ended June 30, 2009, respectively, compared to (\$461,000) and (\$877,000), respectively, for the same period in 2008. The increase in income taxes of \$743,000 and \$1,307,000 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 47.2% and 83.7% for the three and six months ended June 30, 2009, respectively, compared to 31.1% and 33.3% , respectively, for the same periods in 2008.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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):

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Net income / (loss)	\$ 315	\$ (1,020)	\$ 84	\$ (1,754)
Net unrealized gain (loss) on cash flow hedge	51	0	76	0
Reclassification adjustment for gain / (loss) included in income, net of taxes	(31)	0	(57)	0
Other comprehensive income	\$ 20	\$ 0	\$ 19	\$ 0
Total comprehensive income (loss)	\$ 335	\$ (1,020)	\$ 103	\$ (1,754)

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 six months ended June 30, 2009, the Company recognized \$75,000 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. 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 37th Street, New York, NY (the NY Office). 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. 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.

At June 30, 2009 and 2008, other receivables include \$6,000 and \$34,000, 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 of ASI, 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 three and six months ended June 30, 2009, the Company made lease payments of \$123,000 and \$246,000, respectively under these leases.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 13 Related-Party Transactions (continued)

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. June 30, 2009 and December 31, 2008 totaled \$2.7 million and \$4.7 million, respectively, which is disclosed as Contract Receivables Related Party on the face of the unaudited 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 and \$5.3 million for the three months ended June 30, 2009 and 2008, respectively. Contract revenues reported by the Company from ISI*MCS, Ltd. were \$0.9 million and \$12.2 million for the six months ended June 30, 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 June 30, 2009, totaled \$1.6 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.

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 June 30, 2009 and December 31, 2008, the remaining debt to the shareholder (see Note 5) totaled \$11.6 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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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.

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

Note 14 Segment Information (continued)

Summary Segment Information
(in thousands)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Industry Segment (in thousands)				
Revenues:				
Corrections	\$ 21,124	\$ 28,843	\$ 42,997	\$ 58,881
Commercial	9,263	7,663	19,134	15,222
Corporate				
Eliminations				
Total	\$ 30,387	\$ 36,506	\$ 62,131	\$ 74,103
Operating income (loss):				
Corrections	\$ 1,494	\$ 103	\$ 2,596	\$ 1,713
Commercial	840	522	1,755	386
Corporate	(923)	(1,304)	(2,165)	(3,155)
Eliminations				
Total	\$ 1,411	\$ (679)	\$ 2,186	\$ (1,056)
Capital expenditures:				
Corrections	\$ 105	\$ 2,356	\$ 348	\$ 3,006
Commercial	34	191	79	312
Corporate	1	77	4	87
Total	\$ 140	\$ 2,624	\$ 431	\$ 3,405
Total assets:				
Corrections	\$ 54,151	\$ 98,377	\$ 54,151	\$ 98,377
Commercial	10,461	5,942	10,461	5,942
Corporate	24,160	49,404	24,160	49,404
Eliminations	(14,717)	(34,206)	(14,717)	(34,206)
Total	\$ 74,055	\$ 119,517	\$ 74,055	\$ 119,517

Table of Contents

ARGYLE SECURITY, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2009

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

	Six Months Ended	
	June 30, 2009	June 30, 2008
Cash paid for interest	\$ 1,097	\$ 1,335
Cash paid for income taxes	2	520
Supplemental schedule of non-cash investing activities:		
Financed purchases of property and equipment	\$	\$
Issuance of common stock to retire notes with related parties	1,925	
Accrual for deferred transaction costs	132	426
Supplemental schedule of non-cash financing activities:		
Notes issued for acquisitions	\$	\$ 6,765
Dividends accrued	288	86
Accrual of offering costs		302

Note 16 Subsequent Events

As required by FAS 165, the Company has disclosed all material subsequent events that occurred between July 1, 2009 and through August 13, 2009 in this Form 10-Q.

On August 3, 2009, ISI Security Group, Inc. (ISI), a Delaware corporation and wholly owned subsidiary of Argyle Security, Inc. (the Company), entered into an Eighth Amendment and Waiver (the Blair Amendment) to the Note and Warrant Purchase Agreement dated as of October 22, 2004 (as amended) between ISI and William Blair Mezzanine Capital Fund III, L.P. (Blair), a fund managed by Merit Capital Partners (the Agreement). Pursuant to the terms of the Blair Amendment, in exchange for an amendment fee of \$25,000, Blair agreed to waive a default of the negative covenant restricting total indebtedness allowed under the Agreement (the Blair Default) and amend the definition of Permitted Indebtedness to increase the amount of permitted operating real estate lease obligations from \$750,000 in any fiscal year to (1) \$850,000 in the aggregate during the Fiscal Year ending December 31, 2009; (2) \$1,000,000 in the aggregate during the Fiscal Year ending December 31, 2010; (3) \$1,100,000 in the aggregate for during the Fiscal Year ending December 31, 2011; and (4) \$1,200,000 in the aggregate for the Company and its Subsidiaries during the Fiscal Year ending December 31, 2012 and during each Fiscal Year thereafter. Also, the definition of Permitted Indebtedness was amended to separately include any real estate leases entered into specifically in connection with projects undertaken by ISI or its subsidiaries.

In addition, The PrivateBank and Trust Company (the Bank) agreed to waive any cross-default or Event of Default created under the senior credit facility between the Bank and ISI, solely as it relates to occurrence of the Blair Default and ISI and the Bank entered into Amendment No. 3 to Loan and Security Agreement (the Bank Amendment) whereby the Bank Amendment added the same restrictions on the amount of operating lease obligations as those set forth in the Blair Amendment.

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 its 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.

Table of Contents

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.

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.

On June 15, 2009, the Company and MML Capital Partners LLC, in its capacity as advisor to, and on behalf of, Mezzanine Management Fund IV A L.P. and Mezzanine Management Fund Coinvest A L.P. (collectively MML) entered into a non-binding letter of intent (the LOI) to enter into a transaction whereby an entity controlled by MML (the Acquiring Company) would merge its wholly-owned subsidiary into the Company, resulting in the Company becoming a wholly-owned subsidiary of the Acquiring Company. Pursuant to the merger, existing stockholders and unitholders of the Company would receive \$2.00 per share or unit, as applicable, in cash. It is anticipated that certain members of the Company s continuing management team and certain creditors may rollover their shares of Company common stock for common stock of the Acquiring Company based on the \$2 per share price.

Table of Contents

The Company's Board of Directors (the Board) appointed a special committee (the Special Committee) composed solely of independent directors to consider the proposal and recommend it to the Board for approval. The special committee has engaged Houlihan Lokey, as its independent financial advisor, to assist it with its assessment of MML's offer.

The Company had received an original conditional offer from MML on May 19, 2009. Following negotiations, during which the proposed offer price was increased from \$1.00 per share to \$2.00 per share, the Special Committee recommended that the Board authorize the Company to enter into the LOI. Based on the recommendation of the Special Committee, the Board voted to approve the Company entering into the LOI.

Pursuant to the LOI, MML was granted an exclusivity period expiring on the earlier of the execution of a definitive agreement or 45 days after June 15, 2009 (the Exclusivity Period) in which to complete its confirmatory due diligence and execute definitive documentation with the Company. Notwithstanding the expiration of the Exclusivity Period, the Company and MML continue to be engaged in non-binding negotiations involving a proposed transaction.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based on the accompanying unaudited 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 we have 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.

Table of Contents

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.

During the three and six months ended June 30, 2009, the Company conducted regular reviews and evaluations for the cost estimates associated with all of the approximately 1,410 active contracts in the Company's Work-in-Process.

Changes in cost estimates came as the result of 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 June 30, 2009) increased by a net \$1.8 million in quarter ended June 30, 2009. Of the aforementioned net estimated cost increases of \$1.8 million, 19 contracts with cost estimate changes of approximately \$100,000 or greater resulting in \$1.8 million or 98.4% of the total net increases. Ten of the total 19 of the contracts with changes greater than \$100,000 resulted in cost estimate increases totaling \$3.5 million while nine contracts had estimated cost decreases totaling \$1.7 million. Approximately 1,390 of the remaining contracts with variances of less than \$100,000 resulted in a net decrease in cost estimates of \$31,000 or 1.6% of the total net increases.

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 recognizes losses (overruns of cost estimates) as soon as they are determined to be probable and 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 current or 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.

Table of Contents

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 three and six months ended June 30, 2009, the Company collected \$334,000 and \$549,000, respectively and remitted \$244,000 and \$664,000, respectively, 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).

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).

Table of Contents

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. There were no such events that occurred prior to July 1, 2009 and therefore the Company will perform the annual impairment assessment for the 3rd quarter financial statements.

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.

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, 2007 and January 1, 2008, 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 and six month period ended June 30, 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 and six months ended June 30, 2008.

Below is a table of revenues, cost of revenues and gross margins for the three months ended June 30, 2009 and 2008.

	Three Months Ended June 30, 2009			Three Months Ended June 30, 2008			Percent Increase (Decrease)		
	Correction	Commercial	Total	Correction	Commercial	Total	Correction	Commercial	Total
Net revenues									
Contract revenues and contract revenues - related party	\$ 18,544	\$ 6,846	\$ 25,390	\$ 26,371	\$ 5,483	\$ 31,854	(29.7%)	24.9%	(20.3%)
Manufacturing revenues	1,868		1,868	1,923		1,923	(2.9%)	0.0%	(2.9%)
Service and other revenues	711	2,418	3,129	548	2,181	2,729	29.7%	10.9%	14.7%
Total net revenues	\$ 21,123	\$ 9,264	\$ 30,387	\$ 28,842	\$ 7,664	\$ 36,506	(26.8%)	20.9%	(16.8%)
<i>% of total</i>	<i>69.5%</i>	<i>30.5%</i>		<i>79.0%</i>	<i>21.0%</i>				
Cost of revenues									
Contract costs and contract costs related party	\$ 14,544	\$ 5,541	\$ 20,085	\$ 22,093	\$ 4,192	\$ 26,285	(34.2%)	32.2%	(23.6%)
Manufacturing costs	1,122		1,122	1,158		1,158	(3.1%)	0.0%	(3.1%)
Service and other costs	667	1,532	2,199	1,478	1,521	2,999	(54.9%)	0.7%	(26.7%)
Total cost of revenues	\$ 16,333	\$ 7,073	\$ 23,406	\$ 24,729	\$ 5,713	\$ 30,442	(34.0%)	23.8%	(23.1%)
Gross margin									
Contract margins and contract margins -	\$ 4,000	\$ 1,305	\$ 5,305	\$ 4,278	\$ 1,291	\$ 5,569	(6.5%)	1.1%	(4.7%)

Edgar Filing: ARGYLE SECURITY, INC. - Form 10-Q

related party Manufacturing margins	\$ 746	\$	\$ 746	\$ 765	\$	\$ 765	(2.5%)	0.0%	(2.5%)
Service and other margins	44	886	930	(930)	660	(270)	104.7%	34.2%	(444.4%)
Total gross margin	\$ 4,790	\$ 2,191	\$ 6,981	\$ 4,113	\$ 1,951	\$ 6,064	16.5%	12.3%	15.1%
Gross margin percentage									
Contract revenues and contract revenues -									
related party	21.6%	19.1%	20.9%	16.2%	23.5%	17.5%	33.3%	(18.7%)	19.4%
Manufacturing margins	39.9%	0.0%	39.9%	39.8%	0.0%	39.8%	0.3%	0.0%	0.3%
Service and other revenues	6.2%	36.6%	29.7%	(169.7%)	30.3%	(9.9%)	103.7%	20.8%	(400.0%)
Total gross margin percentage	22.7%	23.7%	23.0%	14.3%	25.5%	16.6%	58.7%	(7.1%)	38.6%

Below is a table of revenues, cost of revenues and gross margins for the six months ended June 30, 2009 and 2008.

	Six Months Ended June 30, 2009			Six Months Ended June 30, 2008			Percent Increase (Decrease)		
	Correction	Commercial	Total	Corrections	Commercial	Total	Correction	Commercial	Total
Net revenues									
Contract revenues and contract revenues -									
related party	\$ 36,897	\$ 14,679	\$ 51,576	\$ 54,576	\$ 11,081	\$ 65,657	(32.4%)	32.5%	(21.4%)
Manufacturing revenues	3,769		3,769	3,441		3,441	9.5%	0.0%	9.5%
Service and other revenues	2,331	4,455	6,786	864	4,141	5,005	169.8%	7.6%	35.6%
Total net revenues	\$ 42,997	\$ 19,134	\$ 62,131	\$ 58,881	\$ 15,222	\$ 74,103	(27.0%)	25.7%	(16.2%)
<i>% of total</i>	<i>69.2%</i>	<i>30.8%</i>		<i>79.5%</i>	<i>20.5%</i>				
Cost of revenues									
Contract costs and contract costs related	\$ 29,762	\$ 11,655	\$ 41,417	\$ 44,990	\$ 8,637	\$ 53,627	(33.8%)	34.9%	(22.8%)

party									
Manufacturing costs	2,380		2,380	1,848		1,848	28.8%	0.0%	28.8%
Service and other costs	1,713	2,983	4,696	2,875	3,284	6,159	(40.4%)	(9.2%)	(23.8%)
Total cost of revenues	\$ 33,855	\$ 14,638	\$ 48,493	\$ 49,713	\$ 11,921	\$ 61,634	(31.9%)	22.8%	(21.3%)
Gross margin									
Contract margins and contract margins - related party	\$ 7,135	\$ 3,024	\$ 10,159	\$ 9,586	\$ 2,444	\$ 12,030	(25.6%)	23.7%	(15.6%)
Manufacturing margins	\$ 1,389	\$	\$ 1,389	\$ 1,593	\$	\$ 1,593	(12.8%)	0.0%	(12.8%)
Service and other margins	618	1,472	2,090	(2,011)	857	(1,154)	130.7%	71.8%	(281.1%)
Total gross margin	\$ 9,142	\$ 4,496	\$ 13,638	\$ 9,168	\$ 3,301	\$ 12,469	(0.3%)	36.2%	9.4%
Gross margin percentage									
Contract revenues and contract revenues - related party	19.3%	20.6%	19.7%	17.6%	22.1%	18.3%	9.7%	(6.8%)	7.7%
Manufacturing margins	36.9%	0.0%	36.9%	46.3%	0.0%	46.3%	(20.3%)	0.0%	(20.3%)
Service and other revenues	26.5%	33.0%	30.8%	(232.8%)	20.7%	(23.1%)	111.4%	59.4%	(233.3%)
Total gross margin percentage	21.3%	23.5%	22.0%	15.6%	21.7%	16.8%	36.5%	8.3%	31.0%

Table of Contents**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)

	Three Months Ended		Six Months Ended	
	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
GAAP net income (loss)	\$ 315	\$ (1,020)	\$ 84	\$ (1,754)
Interest, net	814	802	1,672	1,575
Depreciation	480	624	944	1,114
Amortization	414	1,703	865	3,376
Taxes, net	282	(461)	430	(877)
EBITDA	\$ 2,305	\$ 1,648	\$ 3,995	\$ 3,434

Table of Contents**Results of Operations for the Three Months Ended June 30, 2009 and 2008**

The following table sets forth, for the three months ended June 30, 2009 and 2008, certain operating information expressed in U.S. dollars (in thousands):

	Three Months June 30, 2009		Three Months June 30, 2008		Year to Year Increase (Decrease)	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
Revenues:						
Contract revenues	\$ 25,390	83.6%	\$ 26,572	72.8%	\$ (1,182)	(4.4%)
Contract revenues related party		0.0%	5,282	14.5%	(5,282)	(100.0%)
Manufacturing revenues	1,868	6.1%	1,923	5.3%	(55)	(2.9%)
Service and other revenues	3,129	10.3%	2,729	7.5%	400	14.7%
Total revenues	\$ 30,387	100.0%	\$ 36,506	100.0%	\$ (6,119)	(16.8%)
Cost of Revenues:						
Contract costs	\$ 20,085	66.1%	\$ 26,285	72.0%	\$ (6,200)	(23.6%)
Manufacturing costs	1,122	3.7%	1,158	3.2%	(36)	(3.1%)
Service and other costs, including amortization of intangibles	2,199	7.2%	2,999	8.2%	(800)	(26.7%)
Cost of revenues	\$ 23,406	77.0%	\$ 30,442	83.4%	\$ (7,036)	(23.1%)
Gross profit	\$ 6,981	23.0%	\$ 6,064	16.6%	\$ 917	15.1%
Total operating expenses	\$ 5,570	18.3%	\$ 6,743	18.5%	\$ (1,173)	(17.4%)
Other income (expense):						
Interest income	\$ 6	0.0%	\$ 52	0.1%	\$ (46)	(88.5%)
Interest expense	(820)	(2.7%)	(854)	(2.3%)	34	(4.0%)
Total other income (expense)	\$ (814)	(2.7%)	\$ (802)	(2.2%)	\$ (12)	1.5%
Net income (loss)	\$ 315	1.0%	\$ (1,020)	(2.8%)	\$ 1,335	(130.9%)
EBITDA	\$ 2,305	7.6%	\$ 1,648	4.5%	\$ 657	39.9%

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.

Table of Contents

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.

Typically, new bookings will result in revenues within three to six months due to the incubation period for construction projects. Shortfalls in anticipated new sales bookings in the second half of 2008 caused a negative impact on revenue in the first six months of 2009. We have also seen a decrease in new bookings in the first half 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 pipeline (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 \$30.4 million (including related party revenues of \$0) and \$36.5 million (including related party revenues of \$5.3 million) for the three months ended June 30, 2009 and 2008, respectively, representing a decrease of \$6.1 million or 16.8%. 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, which has led to the fewer projects in 2009 and the correspondingly lower revenue. The revenue mix was 83.6% contract revenues and 16.4% manufacturing, service and other revenues for the three months ended June 30, 2009 compared to 87.3% and 12.7%, respectively, for the corresponding period in 2008. Manufacturing revenues represented 6.2% of total revenues in 2009 and 5.3% in 2008.

Year-over-year service and other revenues increased by \$400,000, or 14.7%, to \$3.1 million for the three months ended June 30, 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 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, President and Chief Operating Officer and by Don Carr, Vice President), which subcontracts were entered into prior to our acquisition of ISI. 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.

Table of Contents

Cost of revenues decreased by \$7.0 million, or 23.1%, to \$23.4 million for the three months ended June 30, 2009, compared to \$30.4 million for the corresponding period in 2008. The decrease in cost of revenues resulted from working on fewer projects in the second quarter of 2009 than in 2008 for the reasons described above. 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 \$5.3 million (of which \$1.1 million was recognized in the second quarter) through June 30, 2009. While all probable and quantifiable job 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, during the first part of 2008, 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.

Gross Margin

For the three months ended June 30, 2009, we generated gross profit of \$7.0 million, a \$0.9 million increase over our gross profit of \$6.1 million for the corresponding period in 2008. Our gross profit percentage for the three months ended June 30, 2009 increased to 23.0% from 16.6% for the corresponding period in 2008. However, as discussed previously, our gross margins in the second quarter of 2008 included \$1.3 million of amortization expense compared with only \$74,000 in the second quarter of 2009. Excluding amortization, our gross margin percentage improved by 3.1% from the second quarter of 2008 to the second quarter of 2009. Although we have continued to experience gross margin erosion as a result of cost overruns on certain existing projects, the impact of such cost overruns on our margins has been decreasing as we expected after implementing operational controls during the second half of 2008. We have been able to realize greater margin on certain other projects that have not had cost overruns. Additionally, we believe that our gross margin percentage should continue to improve as overrun jobs are completed and due to the implementation of operational controls on newer jobs. We believe the early financial results from more recent projects indicate that our new operational controls have been successful in enabling us to achieve and in some cases exceed our targeted gross margin percentage on such projects during the first half of 2009.

Operating Expenses

Operating expenses decreased to \$5.6 million for the three months ended June 30, 2009, compared to \$6.7 million for the corresponding period in 2008, a 17.4% decrease. 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 depreciation of fixed assets and amortization of intangible assets. To reduce operating expenses, we have implemented cost reduction initiatives to reduce overhead and discretionary spending.

We had (\$29,000) in non-cash compensation credits resulting from a forfeiture of restricted stock granted and expensed in a previous period. Such credit amount was included in the operating expenses for the quarter ended June 30, 2009, compared to \$191,000 in expense 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 June 30, 2009 was \$0.8 million, compared to expense of \$0.9 million for the corresponding period in 2008. Interest income for the three months ended June 30, 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 June 30, 2009, we had net income of \$315,000, compared to net loss of \$1.0 million for the corresponding period in 2008.

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

EBITDA increased by \$0.6 million to \$2.3 million in the three months ended June 30, 2009, compared to \$1.7 million in the corresponding period in 2008. The EBITDA Margin increased to 7.8% from 4.5% in the corresponding period in 2008. EBITDA for the quarter ended June 30, 2009 includes (\$29,000) in non-cash compensation credits related to a forfeiture of restricted stock granted and expensed in a previous period compared to \$191,000 in non-cash compensation expense related to restricted stock grants and employee options for the same period in 2008.

Results of Operations for the Six Months Ended June 30, 2009 and 2008

The following table sets forth, for the six months ended June 30, 2009 and 2008, certain operating information expressed in U.S. dollars (in thousands):

	Six Months June 30, 2009		Six Months June 30, 2008		Year to Year Increase (Decrease)	
	Amount	% of Revenues	Amount	% of Revenues	Amount	%
Revenues:						
Contract revenues	\$ 50,716	81.6%	\$ 53,432	72.1%	\$ (2,716)	(5.1%)
Contract revenues related party	860	1.4%	12,225	16.5%	(11,365)	(93.0%)
Manufacturing revenues	3,769	6.1%	3,441	4.6%	328	9.5%
Service and other revenues	6,786	10.9%	5,005	6.8%	1,781	35.6%
Total revenues	\$ 62,131	100.0%	\$ 74,103	100.0%	\$ (11,972)	(16.2%)
Cost of Revenues:						
Contract costs	\$ 41,417	66.7%	\$ 53,627	72.4%	\$ (12,210)	(22.8%)
Manufacturing costs	2,380	3.8%	1,848	2.5%	532	28.8%
Service and other costs, including amortization of intangibles	4,696	7.6%	6,159	8.3%	(1,463)	(23.8%)
Cost of revenues	\$ 48,493	78.0%	\$ 61,634	83.2%	\$ (13,141)	(21.3%)
Gross profit	\$ 13,638	22.0%	\$ 12,469	16.8%	\$ 1,169	9.4%
Total operating expenses	\$ 11,452	18.4%	\$ 13,525	18.3%	\$ (2,073)	(15.3%)
Other income (expense):						
Interest income	\$ 31	0.0%	\$ 78	0.1%	\$ (47)	(60.3%)
Interest expense	(1,703)	(2.7%)	(1,653)	(2.2%)	(50)	3.0%
Total other income (expense)	\$ (1,672)	(2.7%)	\$ (1,575)	(2.1%)	\$ (97)	6.2%
Net income (loss)	\$ 84	0.1%	\$ (1,754)	(2.4%)	\$ 1,838	(104.8%)
EBITDA	\$ 3,995	6.4%	\$ 3,434	4.6%	\$ 561	16.3%

Revenues

We had revenues of \$62.1 million (including related party revenues of \$0.9 million) and \$74.1 million (including related party revenues of \$12.2 million) for the six months ended June 30, 2009 and 2008, respectively, representing a decrease of \$12.0 million or 16.2%. Also, as described above, 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 83.0% contract revenues and 17.0% manufacturing, service and other revenues for the six months ended June 30, 2009 compared to 88.6% and 11.4%, respectively, for the corresponding period in 2008. Manufacturing revenues represented 6.1% of total revenues in 2009 and 4.6% in 2008.

Table of Contents

Year-over-year service and other revenues increased by \$1.8 million, or 35.6%, to \$6.8 million for the six months ended June 30, 2009 versus the same period in 2008. This increase was largely attributable to the single service job performed by ISI Detention, as described above. Other business units also experienced more modest increases in their service revenues in the six month period versus 2008.

Cost of Revenues

Cost of revenues decreased by \$13.1 million, or 21.3%, to \$48.5 million for the six months ended June 30, 2009, compared to \$61.6 million for the corresponding period in 2008. As described above, the decrease in cost of revenues resulted from working on fewer projects in the first six months of 2009 than in 2008.

Gross Margin

For the six months ended June 30, 2009, we generated gross profit of \$13.6 million, a \$1.2 million increase over our gross profit of \$12.4 million for the corresponding period in 2008. Our gross profit percentage for the six months ended June 30, 2009 increased to 22.0% from 16.8% for the corresponding period in 2008. However, as discussed previously, our gross margins in the first six months of 2008 included \$2.5 million of amortization expense compared with only \$184,000 in the first six months of 2009. Excluding amortization, our gross margin percentage improved by 2.0% from the first six months of 2008 to the first six months of 2009.

Operating Expenses

Operating expenses decreased to \$11.5 million for the six months ended June 30, 2009, compared to \$13.5 million for the corresponding period in 2008, a 15.3% decrease. As a result in the reduction and control of our operating expenses, general and administrative expenses and professional fees have been reduced to \$2.5 million for the six months ended June 30, 2009 from \$3.3 million for the same period in 2008.

We had \$116,000 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 six months ended June 30, 2009, compared to \$0.8 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 six months ended June 30, 2009 was \$1.7 million, compared to expense of \$1.6 million for the corresponding period in 2008. Interest income for the six months ended June 30, 2009 mainly represents interest earned on the excess cash from the net proceeds of our preferred stock offering.

Net Income / (Loss)

For the six months ended June 30, 2009, we had net income of \$84,000, compared to net loss of \$1.8 million for the corresponding period in 2008.

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

EBITDA increased by \$0.6 million to \$4.0 million in the six months ended June 30, 2009, compared to \$3.4 million in the corresponding period in 2008. The EBITDA Margin increased to 6.5% from 4.6% in the corresponding period in 2008. EBITDA for the six months ended June 30, 2009 includes \$116,000 in non-cash compensation expense related to restricted stock grants and employee stock options for that period compared to \$0.8 million for the same period in 2008.

Table of Contents**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.

Net cash resulting from operating activities for the six months ended June 30, 2009 amounted to \$5.0 compared to net cash (used in) operations of (\$2.6) million for the same period in 2008. The \$7.6 million improvement in cash flow from operating activities for the six months ended 2009 compared to 2008 was attributable to a \$1.8 million lower net loss and \$5.8 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 six months ended June 30, 2009 amounted to (\$431,000) compared to (\$7.3) million for the same period in 2008. The reduction in investing activities was attributed to acquisition related activities in the first half of 2008 which amounted to (\$5.5) million versus \$0 for the same period in 2009 and a \$1.2 million reduction in purchases of property and equipment from first six months of 2009 versus the same period in 2008.

Net cash (used in) financing activities was (\$5.5) million during the six months ended June 30, 2009 compared to net cash provided by financing activities of \$20.2 million for the same period in 2008. The \$25.6 net increase of cash (used in) financing activities was largely attributable to net reduction of \$5.3 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 \$2.6 of net proceeds from the sale of newly created preferred stock in the first quarter of 2009 versus \$13.5 million in net proceeds from the sale of newly created preferred stock in the second quarter of 2008.

At June 30, 2009, we had current assets of \$50.8 million and current liabilities of \$22.4 million, resulting in a working capital surplus of approximately \$28.4 million, compared to a surplus of \$27.7 million and \$22.6 million at March 31, 2009 and December 31, 2008, respectively.

As of June 30, 2009, we had \$15.2 million in cash and cash equivalents, including \$5.0 million of restricted cash, of which \$2.5 million is invested in a certificate of deposit earning interest of 2.5% per year and \$2.5 million is in a non interest bearing depository account, and \$3.6 million of cash which is deposited in Certificate of Deposit Account Registry Service (CDARS) earning interest at a variable rate of return. The remaining \$6.6 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.

Table of Contents

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.

On April 22, 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.

On January 8, 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):

	June 30, 2009		December 31, 2008	
	Book Value	Fair Value	Book Value	Fair Value
Collateral				
Notes payable:				
Vehicles and equipment	\$ 347	\$ 347	\$ 418	\$ 418
Unsecured debt related party	11,626	11,626	11,393	11,393
Unsecured convertible debt stockholders			1,925	1,925
Seller notes	5,205	5,205	6,106	6,106
Line of credit and senior term debt	8,500	8,500	12,951	12,951
	\$ 25,678	\$ 25,678	\$ 32,793	\$ 32,793
Less current maturities	4,185	4,185	3,235	3,235
Long term debt	\$ 21,493	\$ 21,493	\$ 29,558	\$ 29,558

Management has determined that the carrying value of the debt outstanding at June 30, 2009 approximates the fair value based on borrowing rates currently available to the Company for financing arrangements with similar terms and maturities.

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 6.1% and 9.4% at June 30, 2009 and June 30, 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 June 30, 2009, ISI was in compliance with or received waivers of any default of all covenants (See the section entitled "Subsequent Events" below relating to amendments and waivers on August 3, 2009).

Table of Contents

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 an 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 \$8,600 as of June 30, 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.

Table of Contents

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 has 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 the 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 June 30, 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 June 30, 2009 and June 30, 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 date 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 June 30, 2009, ISI is indebted for \$7.0 million in term debt and \$2.0 million through the line of credit. As of June 30, 2009, ISI was in compliance with or received waivers of any default of all covenants (See the section entitled Subsequent Events below relating to amendments and waivers on August 3, 2009).

Aggregate maturities required on all debt at June 30, 2009 are as follows (in thousands):

Year Ending December 31:

2009 (remaining six months)	\$ 1,724
-----------------------------	----------

Edgar Filing: ARGYLE SECURITY, INC. - Form 10-Q

2010	4,963
2011	18,855
2012	66
2013	70
Thereafter	
	\$ 25,678

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 an 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 and was \$8.5 million at June 30, 2009. 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 June 30, 2009, the interest rate swap (liability) had a fair value (net of taxes) of approximately \$96,935 compared to \$117,214 at March 31, 2009 and \$115,997 at December 31, 2008. During the quarter ended June 30, 2009, we recognized interest expense from hedging activities relating to interest rate swaps of \$30,713. During the six months ended June 30, 2009, we recognized interest expense from hedging activities relating to interest rate swaps of \$57,105. There were no ineffective amounts recognized during the quarter ended June 30, 2009, and we do not expect the hedging activities to result in an ineffectiveness being recognized in earnings.

At June 30, 2009, accumulated other comprehensive income included a deferred pre-tax net loss of \$157,107 compared to \$189,973 at March 31, 2009 and \$188,001 at December 31, 2008 related to the interest rate swap. For the quarter ended and six months ended June 30, 2009 and year ended 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 2013. The corporate office lease space in San Antonio, Texas is for 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 \$316,000 and \$217,000 for the three months ended June 30, 2009 and 2008, respectively, and \$658,000 and \$540,000 for the six months ended June 30, 2009 and 2008.

On April 30, 2009, we entered into a Lease Agreement (the NY Lease) relating to approximately 1,350 square feet of property located at 40 West 37th 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 (excluding free rent for two weeks in May 2010). 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

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.

Contractual Obligations

Aggregate amounts at June 30, 2009 are as follows (in thousands):

	Total	< 1 Year	1 < 3 Years	3 < 5 Years	> 5 Years
Principal on Long Term Debt Obligations	\$ 25,678	\$ 4,185	\$ 21,389	\$ 104	\$
Capital Lease Obligations	5,119	516	1,019	986	2,598
Operating Lease Obligations	3,353	1,032	1,618	653	50
Interest on Long Term Debt Obligations	9,409	2,580	4,646	2,183	
Total	\$ 43,559	\$ 8,313	\$ 28,672	\$ 3,926	\$ 2,648

Subsequent Events

On August 3, 2009, ISI Security Group, Inc. (ISI), a Delaware corporation and wholly owned subsidiary of Argyle Security, Inc. (the Company), entered into an Eighth Amendment and Waiver (the Blair Amendment) to the Note and Warrant Purchase Agreement dated as of October 22, 2004 (as amended) between ISI and William Blair Mezzanine Capital Fund III, L.P. (Blair), a fund managed by Merit Capital Partners (the Agreement). Pursuant to the terms of the Blair Amendment, in exchange for an amendment fee of \$25,000, Blair agreed to waive a default of the negative covenant restricting total indebtedness allowed under the Agreement (the Blair Default) and amend the definition of Permitted Indebtedness to increase the amount of permitted operating real estate lease obligations from \$750,000 in any fiscal year to (1) \$850,000 in the aggregate during the Fiscal Year ending December 31, 2009; (2) \$1,000,000 in the aggregate during the Fiscal Year ending December 31, 2010; (3) \$1,100,000 in the aggregate for during the Fiscal Year ending December 31, 2011; and (4) \$1,200,000 in the aggregate for the Company and its Subsidiaries during the Fiscal Year ending December 31, 2012 and during each Fiscal Year thereafter. Also, the definition of Permitted Indebtedness was amended to separately include any real estate leases entered into specifically in connection with projects undertaken by ISI or its subsidiaries.

In addition, The PrivateBank and Trust Company (the Bank) agreed to waive any cross-default or Event of Default created under the senior credit facility between the Bank and ISI, solely as it relates to occurrence of the Blair Default and ISI and the Bank entered into Amendment No. 3 to Loan and Security Agreement (the Bank Amendment) whereby the Bank Amendment added the same restrictions on the amount operating lease obligations as those set forth in the Blair Amendment.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

At June 30, 2009, ISI had a line of credit facility totaling \$11.1 million and \$10.0 million in term debt. The line of credit and term debt are secured by all of our tangible and intangible assets excluding vehicles. Interest on the line of credit is payable quarterly and is calculated at the lender's base rate (greater of prime or federal funds rate) plus 0.5% for the applicable period. Interest on the term debt is payable quarterly and is calculated at 350 basis points in excess of LIBOR for the applicable period. The outstanding balance on the line of credit and term debt at June 30, 2009 was \$7.5 million. The facility has a maturity date of October 2, 2011.

Changes in market rates may impact the bank's LIBOR rate or prime rate. For instance, if either the LIBOR or prime rate were to increase or decrease by one percentage point (1.0%), our annual interest expense would change by approximately \$211,000 based on the total credit available to Argyle.

ITEM 4T. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in reports filed or submitted under the Securities Exchange Act of 1934, as amended (Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to management, including the principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

Our management, under the supervision of our Chief Executive Officer, President and Chief Operating Officer, Chief Financial Officer and Corporate Controller performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2009. Based on that evaluation, our management, including the Chief Executive Officer, President and Chief Operating Officer, Chief Financial Officer and Corporate Controller, concluded that our disclosure controls and procedures were effective as of June 30, 2009.

Changes in Internal Control over Financial Reporting

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

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Albert A. Salas v. Metroplex Control Systems, Inc.; Case No. SA09CA0424XR in the United States District Court, Western District, Texas.

On May 26, 2009, Mr. Albert A. Salas, the plaintiff, filed a complaint and jury demand against Metroplex Control Systems, Inc., the Company's indirect wholly-owned subsidiary, in the U.S. District Court, Western District of Texas. This matter makes claims against Metroplex Control Systems, Inc. for wrongful termination on the basis of race and intentional infliction of emotional distress. An amount of recovery requested is not stated in the complaint and jury demand. Although we intend to vigorously oppose the claim, we may become obligated to pay damages if the court concludes that Metroplex Control Systems, Inc. is liable for wrongdoing.

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

ITEM 1A. RISK FACTORS

In addition to the other information set forth above, you should carefully consider the factors discussed in Part I,

Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

In addition to the risk factors contained in our Annual Report on Form 10-K, you should also consider the following:

Failure to consummate a merger transaction with an entity controlled by MML could reduce the market price of Argyle's common stock and could result in a depletion of Argyle's operating cash.

If a definitive merger agreement is not negotiated and a merger with an entity controlled by MML is not completed for any reason, Argyle may be subject to a number of material risks, including:

The market price of its common stock may decline to the extent that the current market price of its common stock reflects a market assumption that the merger will be consummated;

Costs related to the merger, such as legal and accounting fees, Special Committee fees and the costs of the fairness opinion from Houlihan Lokey, must be paid even if the merger is not completed; and

Charges will be made against earnings for transaction-related expenses, which could be higher than expected.

If the market price of Argyle's securities declines after Argyle fails to consummate a transaction with an entity controlled by MML, persons who purchased Argyle's securities after the entry into the non-binding letter of intent was announced will have lost money investing in Argyle's securities, making future investment in Argyle's securities by such persons less likely. Since most of the fees that Argyle and the Special Committee incurs from Argyle's service providers in connection with the negotiations of definitive documentation must be paid even if Argyle does not consummate the transaction, Argyle will have less cash available for working capital and it may be necessary to raise or borrow additional cash in the future. In addition, since Argyle will have to take charges to earnings for transaction-related expenses even if a transaction is not consummated, Argyle will be a less attractive candidate to be acquired or to acquire a business than another entity that would not have to take such charges.

Argyle's management has been spending and will continue to spend considerable time with activities related to the transaction with MML and, as a result, they may not devote their full attention to Argyle's business.

The negotiation and preparation required to consummate a transaction such as the one with MML requires extensive time and attention from a company's management team. Although Argyle's management team has tried to not allow the transaction with MML to impact their operation of Argyle's business, they may not be able to devote their full time and attention to Argyle's operational issues. Therefore, it is possible that Argyle's business may suffer and its revenues decline due to the diversion of management resources.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

On May 20, 2009, we held our annual meeting of stockholders. Two matters were presented to our stockholders at the meeting:

1. The election of two directors to serve for a three-year term expiring at our 2012 annual meeting of stockholders, and
2. The ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2009.

At the annual meeting, Gen. Wesley Clark was re-elected and Mr. Dean Blythe was elected to our Board of Directors and the appointment of Ernst & Young LLP was ratified. The below table contains information with respect to members of our Board of Directors who were not up for election at this meeting and when their terms expire:

Name	Current Board Term Expires
Bob Marbut	2010
Ron Chaimovski	2010
Lloyd Campbell	2011
Chip Smith	2011

Each share of Common Stock was entitled to one vote and each share of Series B Preferred Stock was entitled to one vote for each share of Common Stock into which the Series B Preferred Shares could have been converted, or 100 shares of Common Stock for each share of Series B Preferred Stock. The holders of the Company's warrants and Series A Convertible Preferred Stock were not entitled to vote. There were 6,267,105 outstanding shares of Common Stock and 27,273 outstanding shares of Series B Preferred Stock (convertible into 2,727,300 shares of Common Stock) entitled to vote. The following tables contain information relating to the voting at the annual meeting:

In the vote for the election of directors:

Name	Votes For	Votes Withheld
Gen. Wesley Clark	7,054,970	11,100
Dean H. Blythe	6,985,224	80,846

In the vote for the ratification of the appointment of Ernst & Young:

Votes For	Votes Against	Abstentions	Broker Non-votes
6,490,717	375,353	0	0

Table of Contents**ITEM 5. OTHER INFORMATION**

On August 11, 2009, Argyle's indirect subsidiary, Detention Contracting Group, Ltd., a Texas limited partnership (the "LP") provided notice to Mr. Sam Youngblood pursuant to the Employment Agreement dated October 19, 2004, between the LP and Mr. Sam Youngblood (the "Agreement"), that the LP has elected to not have the employment period set forth in the Agreement automatically renew until October 19, 2010. Accordingly, the term of the Agreement will end on October 19, 2009. Mr. Youngblood's title as President and Chief Operating Officer, compensation structure and responsibilities to the Company remain unchanged.

Notwithstanding the foregoing, in connection with the notice, Mr. Youngblood and the LP have agreed to extend the term of employment of Mr. Youngblood on the same terms and conditions of the Agreement beyond October 19, 2009, until the earlier to occur of (i) the consummation of a merger transaction (the "Merger") among Argyle and entities controlled directly or indirectly by MML Capital Partners, LLC ("MML") or (ii) upon the termination of negotiations with MML regarding the Merger (each of (i) and (ii) are defined as a "Trigger Event"). Further, this notice does not prohibit the Company or Mr. Youngblood from entering into a new employment agreement with the LP or any of its affiliates before or after the occurrence of a Trigger Event.

The decision to provide the notice was because of the desire of the Company to more similarly align the compensation of all of its executive officers since Mr. Youngblood is the only executive officer of the Company currently with an employment agreement. The decision to provide the notice and the timing of its delivery was unrelated to the negotiations with MML.

ITEM 6. EXHIBITS

Exhibit No.	Description
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, filed herewith.

Table of Contents

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

August 13, 2009

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

August 13, 2009

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

August 13, 2009

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

August 13, 2009

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

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
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, filed herewith.