ARGYLE SECURITY, INC.
Form 10-Q/A
January 24, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q/A
(Amendment No. 1)

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

For the quarterly period ended September 30, 2007.

or

o **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	**20-3101079**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

200 Concord Plaza Suite 700 San Antonio, TX 78216
(Address of Principal Executive Offices including Zip Code)

(210) 828-1700
(Registrant's Telephone Number, Including Area Code)

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 x No o

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

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

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

There were 5,879,342 shares of the Registrant's common stock issued and outstanding as of January 21, 2008.

Argyle Security, Inc. Index to Form 10-Q/A

EXPLANATORY NOTE

Argyle Security, Inc. is filing this Amendment Number 1 to its Quarterly Report on Form 10-Q for the period ended September 30, 2007, which was originally filed with the SEC on November 19, 2007, to remove certain disclosure that was inadvertently not removed prior to filing with the SEC and to correct certain typographical errors. These changes include:

1. Note 18 to the financial statements has been revised to remove paragraphs referencing pro-forma data that were intended to be deleted from the quarterly report prior to filing and to count the amount of total operating income for the three months ended September 30, 2007.

2. Note 19 to the financial statements has been revised.

3. On the consolidated statements of cash flows, under cash flows from financing activities, a line has been added entitled “cash flows from sale of stock”. The amounts in this line-item (which totaled $118 in 2007) was accounted for in the financial results but inadvertently omitted from the filing. Other than the addition of this line-item, no other numbers in our financial statements have been changed.

4. In Item 2, under “pro-forma financial information”, in the second to last sentence of the first paragraph, the phrase “to exclude the amortization of intangible assets and goodwill” has been revised to read “to exclude the amortization of intangible assets.”

5. The section entitled "Pro Forma Financial Information" on page 31 has been changed to "Pro Forma and Adjusted Pro Forma Financial Information". In addition, management has included a discussion regarding the use of these adjusted measurements and why they are relevant to our stockholders.

6. The Sections entitled “Results of operations for the nine-month periods ended September 30, 2007 and 2006” and “Results of operations for the three month periods ended September 30, 2007 and 2006 beginning on pages 34 and 38, respectively, have been modified in the following manner:

a. the use of the term “adjusted “ was eliminated from the sections entitled “Revenues”, “Other Income/Expense” and “Earnings before Interest, Taxes, Depreciation and Amortization.”

b. the Sections previously entitled “Interest, net and Other Income” and “Adjusted Pro-Forma Interest and Other Income” were consolidated into a new section entitled “Other Income/Expense.”

c. the explanation of the increase in adjusted gross margin was revised.

d. the table entitled “Adjusted Pro-Forma Operating Expenses was revised to eliminate the first two rows.

7. The table entitled “Contractual Obligations as of September 30, 2007” was revised by increasing the amount of operating lease obligations for the last year, the total amount of operating lease obligations and the total of the total column.

Except for the foregoing and some minor typographical errors (including the addition of punctuation and the correction of page numbering), the document has not been revised and is being re-filed in its entirety for the purposes of clarity.

PART I - FINANCIAL INFORMATION

ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Argyle Security, Inc.
Consolidated Balance Sheets

	September 30, 2007 (unaudited)	December 31, 2006	Predecessor (ISI) December 31, 2006
Assets			
Cash and cash equivalents	$ 4,281,925	$ 694,115	$ 359,042
Cash and cash equivalents, held in trust	—	29,453,449	—
Receivables:			
Contract receivables - net of allowance for doubtful accounts of $1,109,701 at September 30, 2007 and $411,988 at December 31, 2006.	13,185,067	—	13,430,624
Contract receivables - related party	11,469,117	—	6,262,411
Other receivables - related party	81,577	—	—
Costs and estimated earnings in excess of billings on incomplete contracts	6,771,703	—	3,870,959
Customer backlog	3,798,874	—	—
Refundable income taxes	464,568	—	517,335
Other current assets	169,974	—	128,870
Inventory	182,054	—	229,040
Prepaids	311,536	7,333	315,012
Deferred income taxes	254,803	27,932	—
Total current assets	40,971,198	30,182,829	25,113,293
Property and equipment, net	4,848,099	4,901	3,969,648
Other assets:			
Goodwill	19,762,685	—	1,365,038
Customer relationships	11,419,628	—	—
Trade name	3,776,000	—	—
Software	283,334	—	—
Loan origination fees - less accumulated amortization	—	—	971,898
Deferred transaction costs	—	493,583	—
Deposits and other assets	355,600	—	197,088
Total other assets	35,597,247	493,583	2,534,024
Total assets	$ 81,416,544	$ 30,681,313	$ 31,616,965

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Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable and accrued liabilities	$ 11,981,353	$ 624,129	$ 10,736,153
Billings in excess of costs and estimated earnings on incomplete contracts	8,501,456	—	6,004,689
Deferred underwriting costs	—	1,162,183	—
Current portion of capitalized lease obligations	96,960	—	103,134
Current portion of long-term debt	79,497	—	405,908
Deferred federal income taxes	804,232	—	—
Accrued income taxes payable	—	118,855	—
Accounts payable - related party	39,346	—	1,806,187
Total current liabilities	21,502,844	1,905,167	19,056,071
Long-Term Liabilities:			
Line of credit	7,538,850	—	4,957,850
Deferred federal income taxes	6,158,608	—	247,617
Long-term debt - less current portion	6,105,981	—	13,611,168
Long-term debt - related party	1,925,001	—	—
Long-term capitalized lease obligations - less current portion	1,940,788	—	1,972,352
Total long-term liabilities	23,669,228	—	20,788,987
Total liabilities	45,172,072	1,905,167	39,845,058
Common stock, subject to possible redemption - 764,627 shares at $7.50 per share	—	5,738,206	—
Warrants, subject to redemption shares	—	—	5,018,777
Deferred interest attributable to redemptive shares (net of taxes)	—	175,747	—
Stockholders’ Equity			
Preferred stock of Argyle Security, Inc. - $.0001 par value; 1,000,000 shares authorized; 0 shares issued and outstanding	—	—	—
Common stock of Argyle Security, Inc. - $.0001 par value; 89,000,000 shares authorized; 5,749,342 shares issued and outstanding at September 30, 2007 and 4,781,307 at December 31, 2006	575	478	
Additional paid in capital	35,891,774	22,696,946	—
Stockholders' deficit	—	—	(13,246,870)
Accumulated earnings	352,123	164,769	—
Total stockholders’ equity	36,244,472	22,862,193	(13,246,870)
Total liabilities and stockholders' equity	$ 81,416,544	$ 30,681,313	$ 31,616,965

See notes to unaudited financial statements

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Argyle Security, Inc.
Consolidated Statements of Operations
(unaudited)

	Three Months Ended September 30, 2007	2006	Predecessor (ISI) Three Months Ended September 30, 2006
Net revenues:			
Contract revenues	$ 10,669,686	$ —	$ 5,874,343
Contract revenues - related party	4,558,533	—	7,689,881
Service and other revenues	1,864,254	—	1,890,081
	17,092,473	—	15,454,305
Cost of revenues:			
Contract costs	11,585,962	—	10,807,659
Service and other costs, including amortization of intangibles	1,839,911	—	1,341,558
Cost of revenues	13,425,873	—	12,149,217
Gross profit	3,666,600	—	3,305,088
Operating expenses:			
Selling, general and administrative expenses	3,399,015	229,829	2,277,275
Amortization of intangible assets	222,038	—	—
Total operating expenses	3,621,053	229,829	2,277,275
Operating income / (loss)	45,547	(229,829)	1,027,813
Other income / (expense):			
Bank interest income	46,703	5,173	124
Interest on cash and cash equivalents	127,882	382,549	—
Interest expense	(327,021)	(18,362)	(956,860)
Total other income / (expense)	(152,436)	369,360	(956,736)
Income / (loss) before provision for income taxes	(106,889)	139,531	71,077
Provision for income taxes	9,230	37,484	767
Net income / (loss)	(116,119)	102,047	70,310
Deferred interest, net of taxes, attributable to common stock subject to possible redemption	—	(38,987)	—
Net income / (loss) allocable to holders of non-redeemable common stock	$ (116,119)	$ 63,060	$ 70,310
Weighted-average number of shares outstanding:			
Basic	5,423,156	4,781,307	—
Diluted	5,423,156	4,781,307	—
Net income / (loss) per share:			—
Basic	$ (0.02)	$ 0.02	$ —
Diluted	$ (0.02)	$ 0.02	$ —

Weighted-average number of shares outstanding exclusive of shares subject to possible redemption:						
Basic		5,165,510		4,016,680		—
Diluted		5,165,510		4,016,680		—
Net income / (loss) per share exclusive of shares and related deferred interest subject to possible redemption:						
Basic	$	(0.02)	$	0.02	$	—
Diluted	$	(0.02)	$	0.02	$	—

See notes to unaudited financial statements

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Argyle Security, Inc.
Consolidated Statements of Operations
(unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006	Predecessor (ISI) Nine Months Ended September 30, 2006
Net revenues:			
Contract revenues	$ 10,669,686	$ —	$ 18,867,183
Contract revenues - related party	4,558,533	—	17,447,945
Service and other revenues	1,864,254	—	4,918,677
	17,092,473	—	41,233,805
Cost of revenues:			
Contract costs	11,585,962	—	29,018,321
Service and other costs, including amortization of intangibles	1,839,911	—	3,554,670
Cost of revenues	13,425,873	—	32,572,991
Gross profit	3,666,600	—	8,660,814
Operating expenses:			
Selling, general and administrative expenses	3,919,335	809,278	6,249,385
Amortization of intangible assets	222,038	—	—
Total operating expenses	4,141,373	809,278	6,249,385
Operating income / (loss)	(474,773)	(809,278)	2,411,429
Other income / (expense):			
Bank interest income	50,541	11,409	346
Interest on cash and cash equivalents	895,820	952,609	—
Interest expense	(424,129)	(46,190)	(2,779,773)
Total other income / (expense)	522,232	917,828	(2,779,427)
Income / (loss) before provision for income taxes	47,459	108,550	(367,998)
Provision for income taxes	62,184	37,484	10,312
Net income / (loss)	(14,725)	71,066	(378,310)
Deferred interest, net of taxes, attributable to common stock subject to possible redemption	—	(152,941)	—
Net income / (loss) allocable to holders of non-redeemable common stock	$ (14,725)	$ (81,875)	$ (378,310)
Weighted-average number of shares outstanding:			
Basic	4,997,607	4,375,600	—
Diluted	4,997,607	4,375,600	—
Net income / (loss) per share:			—
Basic	$ (0.00)	$ 0.02	$ —
Diluted	$ (0.00)	$ 0.02	$ —

Weighted-average number of shares outstanding exclusive of shares subject to possible redemption:						
Basic		4,403,832		3,692,197		—
Diluted		4,403,832		3,692,197		—
Net income / (loss) per share exclusive of shares and related deferred interest subject to possible redemption:						
Basic	$	(0.00)	$	(0.02)	$	—
Diluted	$	(0.00)	$	(0.02)	$	—

See notes to unaudited financial statements

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Argyle Security, Inc.
Statement of Changes in Stockholders' Equity
December 31, 2006 through September 30, 2007
(unaudited)

	Shares	Amount	APIC	Accumulated Earnings	Total Shareholders' Equity
Balances, at December 31, 2006	4,781,307	$ 478	$ 22,696,946	$ 164,769	$ 22,862,193
Repayment to redeeming stockholders	(211,965)	(21)	(1,661,097)	—	(1,661,118)
Issuance of additional common stock at $7.78 / share	1,180,000	118	9,180,282	—	9,180,400
Deferred financing costs - warrants	—	—	93,000	—	93,000
Payment of underwriter fees	—	—	(102,924)	—	(102,924)
Release of redemptive reserves	—	—	5,736,341	—	5,736,341
Recognize current period deferred interest	—	—	(101,159)	101,159	—
Recognize deferred interest	—	—	—	100,920	100,920
Stock-based Compensation	—	—	50,385	—	50,385
Net income (Loss)	—	—	—	(14,725)	(14,725)
Balance at September 30, 2007	5,749,342	$ 575	$ 35,891,774	$ 352,123	$ 36,244,472

Argyle Security, Inc.
Consolidated Statement of Cash Flows
(Unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006	Predecessor (ISI) Nine Months Ended September 30, 2006
Cash flows from operating activities			
Net Income (Loss)	$ (14,725)	$ 71,066	$ (378,402)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Stock based compensation	50,384	130,632	—
Amortization	875,165	—	262,080
Depreciation	286,269	1,075	239,482
Payment to ISI*MCS Ltd on Behalf of ISI	(1,918,960)	—	—
Accrued interest on deferred underwriting costs	29,718	45,725	—
Interest accretion and fair market adjustments of warrants	—	—	924,779
Interest earned on assets held in trust	(895,820)	(952,609)	—
Interest income released from the trust	—	600,000	—
Tax payments released from the trust	148,854	—	—
Net Decrease (Increase) in Operating Assets:			
Prepaid & other current assets	(14,484)	(29,333)	—
Contract receivables	(2,386,738)	—	(766,241)
Related party contract receivables	(2,033,052)	—	(4,160,046)
Related party receivables	(42,383)	—	(901)
Other receivables	32,776	—	(16,988)
Inventory	665	—	31,030
Costs and estimated earnings in excess of billings	(1,845,819)	—	(1,385,959)
Prepaids			(21,757)
Deferred income taxes	(226,871)	(34,442)	(655,843)
Deposits and other assets			(150,578)
Net Increase (Decrease) in Operating Liabilities:			
Accounts payable and accrued expenses	2,462,042	162,045	2,615,298
Accrued deferred income taxes	122,084	71,926	—
Deferred interest liability	—	—	—
Billings in excess of cost and estimated earnings	86,713	—	3,378,100
Net cash provided / (used) by operating activities	(5,284,182)	66,085	(85,946)
Cash flow from investing activities:			
Purchase of investments held in trust	(171,372,405)	(249,269,030)	—
Maturity of investments held in trust	171,372,405	220,547,667	—
Acquisition of ISI (net of cash assumed)	(17,157,364)	—	—

Purchase of property and equipment	(53,617)	(6,520)	(376,570)
Transaction costs	(928,576)	—	—
Increase in other assets	(15,970)	—	215,854
Net cash used in investing activities	(18,155,527)	(28,727,883)	(160,716)

Cash flows from financing activities:			
Gross proceeds from public offering and private placement	—	30,600,368	—
Offering costs	(6,885)	(873,356)	—
Proceeds from issuance and exercise of options	—	607	—
Receipt of funds held in trust	30,200,415	—	—
Investment banker fees paid	(1,369,652)	—	—
Repayment on borrowings	(5,137,989)	—	(15,286,909)
Proceeds from borrowings	5,020,000	—	15,428,376
Proceeds from notes payable & warrants stockholders	300,000	—	—
Repayment of notes payable & warrants stockholders	(300,000)	(155,000)	—
Redemption of common stock	(1,661,118)	—	—
Issuance of common stock	118	—	—
Payments on capital lease obligations	(17,370)	—	(56,086)
Net cash provided by investing activities	27,027,519	29,572,619	85,381
Net increase (decrease) in cash	$ 3,587,810	$ 910,821	$ (161,281)
Cash & cash equivalents, beginning of period	694,115	9,608	415,764
Cash and cash equivalents, end of period	$ 4,281,925	$ 920,429	$ 254,483
Supplemental disclosures of cash flow information:			
Cash paid for interest	3,485	3,177	1,877,494
Supplemental schedule of non-cash investing activities:			
Financed purchases property and equipment	160,932	—	—
Supplemental schedule of non-cash financing activities:			
Reduction in deferred interest liability	100,920	—	—
Reduction in deferred underwriter liability	185,115	—	—
Reduction in common stock subject to redemption	5,736,341	—	—
Issuance of warrants associated with notes to related parties	93,000	—	—
Accrual of deferred underwriting costs	—	1,377,017	—

Argyle Security, Inc.

Notes to Unaudited Consolidated Financial Statements
September 30, 2007

Note 1 - Basis of Presentation

The unaudited consolidated financial statements of Argyle Security, Inc. (the "Company" or "Argyle") as of September 30, 2007, and for the three and nine months ended September 30, 2007 and 2006, respectively, include the accounts of the Company and all wholly owned subsidiaries. All significant inter company transactions and balances have been eliminated in consolidation. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results to be expected for a full fiscal year.

The statements and related notes have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the financial statements that were included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the U.S. Securities and Exchange Commission.

Argyle Security, Inc. (formerly Argyle Security Acquisition Corporation) was incorporated in Delaware in June 2005 as a blank check company formed to acquire, through merger, capital stock exchange, asset acquisition, or other similar business combination, a business in the security industry. On July 31, 2007, Argyle consummated its initial acquisition through the acquisition of 100% of the outstanding capital stock of ISI Detention Contracting Group, Inc. and its subsidiaries (ISI). Prior to the acquisition of ISI, Argyle had no operations and was considered a developmental stage enterprise. ISI is deemed to be a "predecessor" to the Company. As a result, the statement of operations and statement of cash flows of ISI for the period ended September 30, 2006 are presented for comparative purposes. The accompanying unaudited consolidated statements of operations and cash flows present the results of operations and cash flows for i) the three months and nine months ended September 30, 2007 period preceding the acquisition of ISI, exclusive of ISI results of operations and cash flows and ii) for the periods succeeding the acquisition, the consolidated results of operations including ISI. The results of operations and cash flows on a consolidated basis subsequent to the acquisition of ISI are not comparative to the predecessor ISI results of operations and cash flows because the basis for the acquired assets and liabilities of ISI have been adjusted to fair value pursuant to Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*.

ISI is a detention equipment contractor that specializes in turnkey installations, including design, engineering, supply, and installation of various detention equipment for correctional facilities and institutions. The work is performed under fixed-price contracts. The projects are located in various cities in the United States. The length of the contracts varies but is typically less than two years. ISI 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.

The Company's operations are classified into three reportable segments, described in further detail in Note 18.

Pro Forma Results of Operations

The accompanying unaudited consolidated statements of operations only reflect the operating results of ISI following the date of acquistion and do not reflect the operating results of ISI prior to the acquisition. Following are pro forma unaudited results of operations for the Company for the three months and nine months ended September 30, 2007 and September 30, 2006 assuming the acquisition of ISI occurred on January 1, 2007 and 2006, respectively:

Argyle Security, Inc
Pro Forma Consolidated Statements of Operations
(unaudited)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Net revenues:				
Contract revenues	$ 12,836,317	$ 5,874,343	$ 30,617,766	$ 18,867,183
Contract revenues - related party	8,132,200	7,689,881	21,298,650	17,447,945
Service and other revenues	2,618,961	1,890,081	8,309,825	4,918,677
	$ 23,587,478	$ 15,454,305	$ 60,226,241	$ 41,233,805
Cost of revenues:				
Contract costs	16,117,788	10,807,659	40,212,278	29,018,321
Service and other costs, including amortization of intangibles	2,650,341	2,181,746	8,690,218	6,075,237
	18,768,129	12,989,405	48,902,496	35,093,558
Gross profit	4,819,349	2,464,900	11,323,745	6,140,247
Selling, general and administrative expenses	4,226,857	2,841,152	10,958,813	8,069,396
Amortization of intangible assets	333,057	333,057	999,171	999,171
Total operating expenses	4,559,914	3,174,209	11,957,984	9,068,567
Operating income / (loss)	259,435	(709,309)	(634,239)	(2,928,320)
Other income / (expense):				
Bank interest income	65,706	62,297	187,339	182,755
Interest expense	(479,379)	(390,811)	(1,305,854)	(1,062,968)
	(413,673)	(328,514)	(1,118,514)	(880,213)
Income / (loss) before provision for income taxes	(154,238)	(1,037,822)	(1,752,753)	(3,808,532)
Provision for income taxes	(58,610)	(394,372)	(666,046)	(1,447,242)
Net income / (loss)	$ (95,627)	$ (643,450)	$ (1,086,707)	$ (2,361,290)
Weighted-average number of shares outstanding:				
Basic	5,749,342	5,749,342	5,749,342	5,310,111
Diluted	5,749,342	5,749,342	5,749,342	5,310,111
Net income / (loss) per share:				
Basic	$ (0.02)	$ (0.11)	$ (0.19)	$ (0.44)
Diluted	$ (0.02)	$ (0.11)	$ (0.19)	$ (0.44)

Weighted-average number of shares outstanding exclusive of shares subject to possible redemption:								
Basic		5,749,342		5,749,342		5,749,342		5,310,111
Diluted		5,749,342		5,749,342		5,749,342		5,310,111
Net income / (loss) per share exclusive of shares and related deferred interest subject to possible redemption:								
Basic	$	(0.02)	$	(0.11)	$	(0.19)	$	(0.44)
Diluted	$	(0.02)	$	(0.11)	$	(0.19)	$	(0.44)

See notes to unaudited financial statements

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The Company derived the pro forma results of operations from (i) the unaudited consolidated financial statements of ISI from January 1, 2007 to July 31, 2007 (the date of the ISI acquisition) and the three months and nine months ended September 30, 2006, and (ii) the unaudited consolidated financial statements of the Company for the three months and nine months ended September 30, 2007 and September 30, 2006. The pro forma results of operations are not necessarily indicative of results of operations that may have actually occurred had the merger taken place on the dates noted, or the future financial position or operating results of the Company or ISI. The pro forma adjustments are based upon available information and assumptions that the Company believes are reasonable. The pro forma adjustments include adjustments for interest expense (relating primarily to interest on the $10.0 million of principal of the unsecured debt of a related party) and increased depreciation and amortization expense as a result of the application of the purchase method of accounting based on the fair values of the tangible and intangible assets of ISI. Additionally, the pro forma results of operations do not include approximately $1.4 million in non-recurring charges relating to the stock appreciation rights incurred in connection with the acquisition.

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

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

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

As part of the ISI merger, public stockholders holding 211,965 of the aggregate number of shares sold in the Public Offering elected to redeem such shares (see Note 12). The per share redemption price was equal to $7.80 per share including interest earned thereon in the trust account, net of taxes payable, $0.6 million of interest income which was released from the trust account in September 2006 to fund our working capital, and amounts owed to the underwriter for the Private Placement (approximately $0.5 million plus interest). Approximately $1.6 million was paid to redemptive shareholders in August of 2007.

In the 2006 annual report on Form 10-K, Argyle disclosed that declining cash available outside the trust account and the lack of assurance that the Company would be able to successfully complete a business combination within the required time frame raised substantial doubt about Argyle’s ability to continue as a going concern. With the completion of the ISI acquisition and release of the funds held in trust, there is no longer substantial doubt about Argyle’s ability to continue as a going concern.

Cash and Cash Equivalents

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

Contracts Receivable

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

Revenue Recognition

The Company receives its revenues primarily from performance of fixed-price construction contracts and from service sales.

Construction Contracts

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

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

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

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

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

Inventory

Inventory is valued at the lower of cost or market and consists primarily of finished goods. Costs of finished goods are determined using the average cost method. Inventory that was acquired from ISI has been stated at fair value at July 31, 2007; all subsequent purchases are recorded based on cost.

Property and Equipment

Property and equipment is stated at cost less accumulated depreciation, except for the plant and equipment acquired in the ISI acquisition which has been recorded at fair value at July 31, 2007 (see Note 4); all subsequent purchases are recorded based on cost. Depreciation is calculated on the straight-line method based on the following estimated useful lives: leasehold improvements - 12 to 15 years, furniture, fixtures, and equipment - 3 to 10 years, and vehicles - 3 to 7 years.

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

Assets Held Under Capital Leases

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

Goodwill and Other Intangible Assets

Goodwill represents the excess of consideration paid over the fair value of net assets acquired in the business combination in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Goodwill and other indefinite-lived intangibles (trade name) are not amortized but are tested at least annually for impairment. The Company must recognize an impairment loss if, and to the extent that, goodwill exceeds fair value. The Company has determined that no impairment exists at September 30, 2007.

The Company has three primary reporting units that provide different services and products. Accordingly, goodwill was allocated to each. Management believes that the relationship between allocation of identified tangible and intangible assets to be in similar proportion to how goodwill is to be allocated among its reporting units. Accordingly, each reporting division was allocated its share of goodwill based upon its percentage of purchase price allocation related to identified tangible and intangible assets. As a result, goodwill was allocated in the approximate percentages as follows: ISI Detention 18%; MCS Detention 48%; and MCS Commercial 34%. Additionally, unidentified intangible assets were allocated in the approximate percentages as follows: ISI Detention 10%; MCS Detention 48%; and MCS Commercial 42%. These amounts are included in each reporting division's segment reporting.

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

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.

Fair Value of Financial Instruments

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

Income Taxes

The Company accounts for income taxes 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.

Reclassifications

Certain prior period predecessor balances have been reclassified to conform to the current period presentation.

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this standard relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company does not believe the adoption of the provisions of SFAS No. 157 will materially impact its consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, T*he Fair Value Option for Financial Assets and Liabilities*. SFAS No. 159 permits all entities to choose to elect to measure eligible financial instruments at fair value. SFAS No. 159 applies to fiscal years beginning after November 15, 2007, with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157. The Company does not believe the adoption of SFAS No. 159 will have a material impact on its consolidated financial position or results of operations.

Use of Estimates

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

Contingencies

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

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

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed.

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. No unaffiliated customer accounts for more than 10% of revenues. See Related-Party Transactions footnote (see Note 17) for discussion of transactions with ISI*MCS, Ltd.

Net Income (Loss) Per Share

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

Since the Company reported a net loss for the three months ended and nine months ended September 30, 2007, all common stock equivalents would be anti-dilutive and the basic and diluted weighted average shares outstanding are the same.

Note 3 - Contract Receivables

Contract receivables consist of the following as of September 30, 2007:

Completed contracts and contracts in progress	$	20,523,289
Retainage		4,130,895
	$	24,654,184

Note 4 - ISI Acquisition

On July 31, 2007, following the stockholder approval and pursuant to the terms of the merger agreement, Argyle acquired all of the assets and liabilities of ISI. The acquisition was accounted for in accordance with the provisions of SFAS No. 141 and 142. As a result of the merger, ISI became a wholly owned subsidiary of Argyle. See Note 1 and 18 for a description of ISI operations.

At the closing of the merger, the following consideration was paid by the Company to the stockholders and debt holders of ISI:

- $18.6 million in cash
- 1,180,000 shares of common stock of Argyle (valued at approximately $9.2 million)
- $1.9 million of unsecured promissory notes convertible into shares of common stock of the Company at a conversion price of $10 per share

The value of Argyle common stock issued as merger consideration is based on the average closing price of Argyle's common stock for the two days prior to, including the day of, and two days subsequent to the second amendment to the merger agreement resulting in the final negotiated purchase price (June 29, 2007) of $7.78. Based on the cash paid, common stock and convertible promissory note issued, and capitalized merger transaction costs of $2.7 million, the transaction was valued for accounting purposes at $32.4 million.

The acquisition of ISI is accounted for as a business combination in accordance with SFAS No. 141 with Argyle as the acquirer. Under the purchase method of accounting, the assets and liabilities of ISI acquired are recorded as of the acquisition date at their respective fair values, and added to those of Argyle. The following table summarizes the estimated fair value of assets acquired and the liabilities assumed and related deferred income taxes at the date of the acquisition.

All amounts below are depicted in thousands (000's):

Current assets	$	27,892
Property and equipment		4,915
Goodwill		19,763
Customer relationships		11,625
Customer backlog		4,359
Trade name		3,776
Software		300
Deposits and other assets		229
Total assets acquired		72,859
Current liabilities		(17,052)
Deferred income taxes		(6,722)
Debt		(13,681)
Obligations under capital leases		(2,055)
Other liabilities		(991)
Total liabilities assumed		(40,500)
Allocated purchase price	$	32,359

The primary reasons for the acquisition were the physical security solutions to commercial, governmental, and correctional customers provided by ISI. As a security solutions provider, ISI has the ability to interview a customer, assess needs, and determine solutions within the customer's budget. The security systems provided to customers are fully integrated security systems. Using its expertise, ISI develops security systems specific to each customer's needs. Most hardware and software is purchased from third parties or involves ISI's own proprietary software. ISI does not manufacture any products. ISI makes these disparate systems effectively communicate, react, and work together. This communication is made possible because of the proprietary development software that ISI has created. ISI does not sell or license this software. ISI customers get "one-stop" shopping for customized solutions to their physical security needs. The customer can look to ISI as the sole source for the solution to all of its physical security needs, even if those needs require hardware and software from many different manufacturers.

The purchased intangibles and goodwill are not deductible for tax purposes. However, purchase accounting allows for the establishment of deferred tax liabilities on purchased intangibles (other than goodwill), which will be reflected as a tax benefit on our future consolidated statements of income in proportion to and over the amortization period of related intangible assets.

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

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

Costs and estimated earnings on incomplete contracts and backlog information are as follows as of September 30, 2007:

Amended contract amount	$ 212,876,483
Revenue recognized to date	112,325,095
Unearned contract amount - backlog	$ 100,551,388
Costs incurred to date	$ 93,278,854
Estimated cost to complete	81,754,514
Estimated total cost	$ 175,033,368
Billings to date	$ 114,045,805
Costs and estimated earnings in excess of billings on incomplete contracts	$ 6,771,703
Billing in excess of costs and estimated earnings on incomplete contracts	$ 8,501,456

Backlog is the aggregate contract amount less revenue recognized using percentage-of-completion accounting as described in Note 1 of these consolidated financial statements. The Company recognizes as backlog only those contracts on which it has received signed contracts or executed letters of intent to award a contract from its customers. The Company also verifies funding is in place on the contracts prior to inclusion in backlog.

The various subsidiary companies often function as subcontractors to other subsidiary companies. The above schedule is computed on a consolidated basis. 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.

Note 6 -Long-Term Debt

Notes payable and long-term debt consists of the following:

Collateral	Monthly Installments	Interest Rate	Payable Through		September 30, 2007
Notes payable:					
Vehicles and equipment	$430 to $3,861	(A)	2008-2011	$	233,869
Unsecured debt - related party		11.58%	2010		5,951,609
Unsecured convertible debt - stockholders		5.00%	2012		1,925,001
					8,110,479
Less current maturities					79,497
Long-term debt for notes - less current maturities				$	8,030,982
Line of credit		Prime + 0.50% or LIBOR + 350 bps	2009	$	7,538,850

(A) Amounts include notes related to Company vehicles and various equipment. Vehicle and equipment notes are staggered in regards to their maturity, each amortizing over 36 - 48 month periods.

Interest rates on the individual notes range from fixed rate of 7% up to Prime plus 1.0%. Included with the equipment is a note related to the phone system with a fixed rate of interest at 9.0% which matures in 2008.

Unsecured Debt - Related Party

All notes are unsecured and subordinated to the line of credit facility. The unsecured note agreement contains prepayment options without prepayment penalties. Interest accrues at 11.58% per annum and is payable quarterly. The total debt of $6.0 million is due and payable in one single payment on January 31, 2010. There are both financial and restrictive covenants associated with the note agreement. As of September 30, 2007. The Company was in compliance with all covenants except the covenants related to capital expenditures and vehicle purchases. The covenant limits capital expenditures to $0.6 million annually, and the Company has spent approximately $1.4 million as of September 30, 2007. The Company obtained a waiver from the lender curing the default through December 31, 2007, provided that capital expenditures do not exceed $1.8 million for fiscal year 2007. The Company obtained a waiver from the lender curing the vehicle purchase default through October 31, 2007. The Company has cured the default as of November 14, 2007 by prepaying a portion of the vehicle loan indebtedness.

Unsecured Convertible Debt - Stockholders

As part of the merger consideration, the Company issued unsecured convertible debt to the stockholders in the amount of $1.9 million which bears interest at 5% per annum, paid semiannually. The notes mature five years from the date of issuance on July 31, 2012. The notes may be converted in whole or in part into shares of the Company’s common stock at the election of the note holder at a share price of $10 any time after January 1, 2008. The debt may be redeemed by the Company at $10 per share any time after January 1, 2009.

Unsecured Debt - Stockholders

In April 2007, Argyle's officers and directors, an affiliate of Argyle's Chairman and Co-Chief Executive Officer, and certain of Argyle's consultants, pursuant to a note and warrant acquisition agreement, loaned Argyle an aggregate of $0.3 million and in exchange received promissory notes in the aggregate principal amount of $0.3 million and warrants to purchase an aggregate of 37,500 shares of Argyle's common stock. The warrants are exercisable at $5.50 per share of common stock and expire on January 24, 2011. The warrants also may be exercised on a net-share basis by the holders of the warrants. The Company has estimated, based upon a Black-Scholes model, that the fair value of the warrants on the date of issue was approximately $2.48 per warrant (a total value of approximately $.09 million) using an expected life of 2 years, volatility of 2.39%, and a risk-free rate of 5%. However, because the Company's warrants have a limited trading history, the volatility assumption was based on information currently available to management. The promissory notes had an interest at a rate of 4% per year and were repayable 30 days after the consummation of a business combination. The notes and the associated accrued interest were paid in full In August 2007.

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Line of Credit Facility

The Company has a line of credit facility totaling $9.0 million. The line of credit is secured by all tangible and intangible assets of the Company excluding vehicles. The line calls for all accounts receivable collections to be deposited directly to a lockbox. Interest is payable quarterly and is calculated at the lender's base rate greater of (prime or federal funds rate) plus 0.5% or 350 basis points in excess of LIBOR for the applicable period. The outstanding balance on the line at September 30, 2007 was $7.5 million due December 31, 2009 with an interest rate of prime plus 0.5%. The agreement contains both financial and restrictive covenants, including a restriction on the payment of dividends. At September 30, 2007, the Company was in compliance with such covenants. The Company has agreed to pay an annual commitment fee of 0.5% per year on the unused borrowing capacity, which was $1.5 million at September 30, 2007.

Aggregate maturities required on all debt at September 30, 2007 are as follows:

Year Ending December 31		
2007 (remaining 3 months)	$	24,438
2008		79,497
2009		7,595,579
2010		5,995,143
2011		29,671
Thereafter		1,925,001
Total commitment outstanding	$	15,649,329

Note 7 - Capitalization of Leases

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

The leased property, included in property and equipment in the accompanying consolidated balance sheet, amounted to $1.8 million at September 30, 2007. As of September 30, 2007 depreciation of these assets amounted to $27,907.

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

The following is a schedule by years of future minimum lease payments under capital leases together with the present value of net minimum lease payments at September 30, 2007:

Year Ending December 31		
2007 (remaining 3 months)	$	72,000
2008		288,000
2009		288,000
2010		288,000
2011		288,000
Thereafter		2,208,000
Future minimum lease payments		3,432,000
Less amount of net minimum lease payments attributable to interest		(1,394,252)
Present value of net minimum lease payments	$	2,037,748
Current portion of capitalized lease obligations	$	96,960
Long-term portion of capitalized lease obligations		1,940,788
	$	2,037,748

Note 8 - Commitments

The Company leases office space and equipment under operating leases expiring through 2011.

Minimum rental commitments at September 30, 2007 are as follows:

Year Ending December 31		
2007 (remaining 3 months)	$	67,450
2008		224,104
2009		104,188
2010		60,352
2011		17,272
Thereafter		—
Total commitment outstanding	$	473,366

The corporate office lease space of Argyle expired as of July 31, 2007 and Argyle currently operates under a month-to-month lease arrangement. No lease agreements contain bargain purchase options or similar clauses in which management intends to execute or that are considered material requiring disclosure.

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

Note 9 - Self Insurance

ISI is self-insured to certain limits under its group health and dental plans. Stop-loss coverage is provided for claims above $75,000 per employee up to a maximum $925,000. Operations are charged with the cost of claims reported and an estimate of claims incurred but not reported based on prior experience. The determination of such claims and expenses and the appropriateness of the related liability are continually reviewed and updated. Total claims payable and claims incurred but not reported were $544,323 at September 30, 2007. ISI has not yet met its stop-loss limit for 2007.

Note 10 - Offerings

Public Offering

In January 2006, Argyle sold 3,700,046 units (which included 75,046 units sold by the underwriters pursuant to a partial exercise of their over-allotment option) to the public at a price of $8.00 per unit. Each unit consists of one share of the Company's common stock, $0.0001 par value, and one redeemable common stock purchase warrant (warrant). Each warrant entitles the holder to purchase from the Company one share of common stock at an exercise price of $5.50 commencing the later of the completion of a business combination with a target business or January 24, 2007, and expiring January 24, 2011. The warrants are redeemable by the Company at a price of $.01 per warrant upon 30 days' notice after the warrants become exercisable, only in the event that the last sale price of the common stock is at least $11.50 per share for any 20 trading days within a 30-trading-day period ending three business days before a notice of redemption is delivered.

Private Placement

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

Note 11 - Common Stock Reserved for Issuance

As of September 30, 2007, 5,839,342 shares of common stock were reserved for issuance upon exercise of redeemable warrants and 375,000 shares of common stock were reserved for issuance pursuant to the underwriters' unit purchase option described above. In addition, warrants were issued in connection with the notes to stockholders entitling the holder to exercise the warrants for a total of 37,500 shares of stock. In August 2007, the company granted certain employees incentive stock options (ISOs) and non-qualified stock options entitling the holder to exercise options for a total of 125,000 shares of stock and 90,000 shares of restricted stock.

Note 12 - Redemptive Status of Common Stock

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

Note 13 - Preferred Stock

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

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

Note 14 - Agreement With Underwriters

In March 2007, the underwriters from Argyle's Public Offering agreed to forfeit any and all rights or claims to a pro-rata portion of the deferred underwriting costs and associated accrued interest with respect to any shares of common stock that are redeemed in connection with the proposed acquisition. This fee was charged against additional paid-in capital and was payable upon a successful business combination. Based on the redemption of 211,965 shares, $0.08 million related to these waived underwriter fees had been included in payable to redemptive stockholders. Upon closing of the purchase of ISI, Argyle paid approximately $1.4 million for services performed related to Argyle's Public Offering.

Note 15 - Stockholders' Equity and Stock-Based Compensation

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

2005 - 2006 Options

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

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

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

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 will be exercisable at $8.80 per unit commencing on the later of the consummation of a business combination or one year from January 24, 2006, and expiring January 24, 2011. The options to purchase the 187,500 units and the Securities underlying such units have been deemed compensation by the National Association of Securities Dealers (NASD) and are therefore subject to a 180-day lock-up pursuant to Rule 2710(g) (1) of the NASD Conduct Rules. Additionally, these options may not be sold, transferred, assigned, pledged, or hypothecated for a one-year period (including the foregoing 180-day period) following January 24, 2006. However, these options may be transferred to any underwriter and selected dealer participating in the offering and their bona fide officers or partners.

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

2007 Incentive Plan

The 2007 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.

In August 2007, the Company awarded a grant of 90,000 restricted common shares (one-third vests on December 31 of each 2008, 2009, and 2010) and 90,000 performance unit shares (vests on December 31, 2010 if certain performance goals to be determined by the Board of Directors are achieved) to various members of the executive management team.

The Company has estimated that the fair value of the restricted shares was approximately $4.45 per unit, (a total value of approximately $0.4 million) using a discount rate of 40%. The discount estimate was derived using historical data of public companies in the related industry. The Company believes the discount rate estimate calculated from these companies was a reasonable benchmark to use in estimating the expected discount of our shares of common stock.

In August 2007, the Company awarded a grant of 125,000 stock options to various employees, of which 91,000 were ISO and 34,000 were non-qualified. The options have a strike price of $7.80 and vest one-third on December 31 of each of 2008, 2009, and 2010.

The Company has estimated, based upon a Black Scholes model, that the fair value of the stock options on the date of grant was approximately $2.10 per unit, (a total value of approximately $0.3 million), using an expected life of three years, volatility of 49%, and a risk-free rate of 4%. However, because the shares did not have a trading history, the volatility assumption was based on information currently available to management. The volatility estimate was derived using historical data of public companies in the related industry. The Company believes the volatility estimate calculated from these companies was a reasonable benchmark to use in estimating the expected volatility of our units;

however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.

Note 16 - Income Taxes

The following temporary differences gave rise to the deferred tax liability at September 30, 2007:

Deferred Tax Liabilities:		
Intangibles (non-amortizable)	$	(7,325,578)
Property and Equipment		(456,586)
Construction Contracts		(315,069)
Prepaid Assets		(69,449)
Other		(11,401)
Total Deferred Tax Liabilities		(8,178,083)
Deferred Tax Assets:		
Net Operating Loss / Capital Loss Carry-forwards		878,682
Allowance for Doubtful Accounts		421,686
Loan Origination Fees		117,423
Capital Leases		89,604
Stock -based Compensation		61,546
Total Gross Deferred Tax Assets		1,568,940
Valuation Allowance		(98,894)
Total Deferred Tax Assets		1,470,046
Net Deferred Tax Liabilities	$	(6,708,037)

The valuation allowance is related to capital losses incurred by the Company which can only be used to offset future capital gains. At September 30, 2007, we had net operating loss/charitable contributions carryovers of $2.1 million and capital loss carryovers of $0.2 million that expire September 30, 2026 and September 30, 2009, respectively.

Note 17 - Related-Party Transactions

Other receivables include $81,577 of receivables from related parties, of which $47,577 is attributable to ISI. Amounts represent monies or other assets advanced to employees. Amounts have been paid on these receivables and management believes they are fully collectible.

Argyle has notes payable totaling $1.9 million to stockholders discussed in Note 6.

Note 17 - 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% fee. ISI recorded contract revenue based on the ISI*MCS, Ltd.'s contract amount, net of the 2% fee. Contract receivables from ISI*MCS, Ltd. at September 30, 2007 totaled $11.5 million, which is disclosed as contract receivables - related party on the face of the consolidated balance sheet since ISI*MCS, Ltd. is not consolidated in the balance sheet. Argyle has agreed to indemnify the shareholders of ISI*MCS, Ltd. from claims brought by the bonding company against their personal guarantees for those contracts that have not been paid in full as of the closing of the merger. The merger agreement provides that these indemnification obligations will survive for a period of four years after the closing date of the merger and the obligations are not subject to cap, or maximum amount.

As of July 31, 2007 ISI will receive 100% of the remaining contract amounts and ISI*MCS, Ltd. will forego its 2% fee. Remaining amounts to be billed on these contracts as of September 30, 2007 totaled $25.0 million. All future contracts, bonded and unbonded, will be contracted directly by ISI without involvement by ISI*MCS, Ltd.

Unsecured Debt - Related Party

As part of the ISI merger transaction, a shareholder of ISI had debt totaling $16.0 million of which $10.0 million was paid prior to its original terms. The shareholder became a shareholder of Argyle as part of the merger and holds 486,237 shares of Argyle common stock as of July 31, 2007 and as such, became a related party. The remaining debt to the shareholder (see Note 6) totals $6.0 million.

Note 18 - Segment Information

The Company's segments are strategic business units that offer different products and services and are managed accordingly. Under GAAP segment reporting rules, management analyzes the various operating segments based on segment income before income taxes. The customers and long-lived assets of the reportable segments are in the United States. The Company has three reportable segments that reflect the current management of its business: (1) ISI Detention; (2) MCS Detention; and (3) MCS Commercial.

ISI Detention offers a complete array of electronic security system solutions revolving around electronic locking systems and hardware, security doors and frames, jail furniture, security glazing, and other security-based systems. Whether acting as prime contractor or as a subcontractor for projects spanning all levels of security, ISI Detention's 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.

MCS Detention specializes in turnkey installations for public- and privately-owned/operated detention facilities. MCS Commercial has built a parallel business targeting commercial and industrial facilities. MCS Detention designs, assembles, supplies, installs, and maintains access control, video, and integrated electronic control systems for correctional and government facilities throughout the United States. It also provides the above goods and services to detention market integrators, electrical contractors, and competitors of ISI that lack their own in-house electronic solutions.

Note 18 - Segment Information (continued)

MCS Commercial currently operates out of its own San Antonio headquarters and five regional offices. The offices in Austin, Houston, and Denver resulted from acquisitions made by ISI.

The results for the three and nine month ended September 30, 2007 represent the two months of activity for the Company since the date of the acquisition of ISI on July 31, 2007. The predecessor information for the three and nine months ended September 30, 2006 represent the full results for those respective time periods.

Argyle Security, Inc.
Segment Information for the Nine Months Ended 2007 & 2006
(unaudited)

			Predecessor (ISI)	
Industry Segment (in $)	**Three Months Ended September 30, 2007**	**Nine Months Ended September 30, 2007**	**Three Months Ended September 30, 2006**	**Nine Months Ended September 30, 2006**
Net Revenues:				
ISI Detention	$ 9,340,490	$ 9,340,490	$ 9,753,455	$ 21,326,269
MCS Detention	4,501,561	4,501,561	2,889,179	9,919,561
MCS Commercial	5,423,640	5,423,640	6,570,854	16,599,478
Corporate	—	—	—	—
Eliminations	(2,173,217)	(2,173,217)	(3,759,184)	(6,611,503)
Total	$ 17,092,474	$ 17,092,474	$ 15,454,304	$ 41,233,805
Operating Income / (Loss):				
ISI Detention	$ 344,024	$ 344,024	$ 539,912	$ 268,331
MCS Detention	24,728	24,728	(69,441)	1,295,906
MCS Commercial	156,201	156,201	457,451	636,322
Corporate	(890,723)	(1,411,042)	—	—
Eliminations	411,316	411,316	99,891	210,870
Total	$ 45,547	$ (474,773)	$ 1,027,813	$ 2,411,429
Total Assets:				
ISI Detention	$ 72,904,116	$ 72,904,116	$ 23,866,660	$ 23,866,660
MCS Detention	5,091,536	5,091,536	2,421,830	2,421,830
MCS Commercial	6,811,175	6,811,175	4,358,558	4,358,558
Corporate	5,363,150	5,363,150	—	—
Eliminations	(8,753,433)	(8,753,433)	473,500	473,500
Total	$ 81,416,544	$ 81,416,544	$ 31,120,548	$ 31,120,548

Note 19 - Subsequent Events

Stock-Based Compensation

In October 2007, the Company awarded a grant of 35,000 restricted shares[1] and 15,000 performance unit shares[2] to various members of the executive management team.

In January 2008, the Company awarded a grant of 61,000 restricted shares[1] and 60,000 performance unit shares[2] to various members of the executive management team.

[1] One-third vests on December 31 of each of 2008, 2009, and 2010.

[2] Vests on December 31, 2010 if certain performance goals to be determined by the Board of Directors are achieved.

Related Party Transaction

On January 2, 2008 ISI entered into and consummated a Third Amendment to Note and Warrant Purchase Agreement ("Note Purchase Agreement") with a related party and existing lender (Note 6) of ISI and Argyle, pursuant to which ISI issued and sold to the party a Senior Subordinated Promissory Note ("Note A") in the aggregate principal amount of $5,000,000, due and payable on January 31, 2010, with interest thereon at 11.58% per annum, payable quarterly in arrears beginning March 31, 2008, deferred interest at the rate of 8.42% per annum, and default interest at 2% per annum. Argyle and each of ISI's subsidiaries are parties to the Note Purchase Agreement as guarantors.

Entry into a Material Definitive Agreement.

On January 7, 2008, ISI Controls, Ltd. ("ISI-Controls"), a wholly owned subsidiary of ISI Security Group, Inc. ("ISI"), which in turn is wholly owned by Argyle Security, Inc. ("Argyle"), entered into a Unit Purchase Agreement (the "Unit Purchase Agreement") with the holders of units (the "Seller") in Com-Tec Security, LLC ("Com-Tec") and Jeffery E. Corcoran, as representative of the Seller, pursuant to which ISI-Controls will acquire 100% of the units of Com-Tec, resulting in Com-Tec becoming a wholly owned subsidiary of ISI-Controls. Com-Tec is engaged in the business of custom design, manufacture and installation of electronic security and communication systems.

In consideration for the sale of the units to ISI-Controls, the Seller will receive cash in the amount of $3,000,000 and a secured subordinated promissory notes in the aggregate principal amount of $3,515,000. The aggregate principal amount of the promissory notes may be reduced depending on the occurrence of certain events described in the Unit Purchase Agreement. The promissory notes will be secured by the assets of ISI Security and Argyle, will bear interest at the rate of 7% per year and will become due and payable on April 1, 2011. Events of default under the promissory notes will consist of failure to pay, bankruptcy or insolvency.

The Seller and the Company make certain representations and warranties in the Unit Purchase Agreement and the transaction is anticipated to close on or prior to January 31, 2008, subject to satisfaction of closing conditions, including:

- ISI-Controls completing its due diligence and the Seller and Com-Tec having complied in all material respects with the terms of the agreement; and
- ISI-Controls making the applicable payment to the Seller and having complied in all material respects with the terms of the Unit Purchase Agreement.

If the transaction is not consummated by January 31, 2008, either party may terminate the Agreement at any time.

The description of the Asset Purchase Agreement, Promissory Notes and Employment Agreements contained in Section 2.01 are incorporated by reference into this Item 1.01.

Completion of Acquisition or Disposition of Assets

On January 4, 2008, ISI Detention Contracting Group, Inc. (“ISI-Detention”), a California corporation and wholly owned subsidiary of ISI, entered into an Asset Purchase Agreement (the “Asset Purchase Agreement”) with Peterson Detention, Inc. (“Peterson Detention”), effective January 1, 2008, pursuant to which ISI-Detention acquired substantially all of the business assets and liabilities of Peterson Detention. Michael Peterson and Leonard Peterson, each an officer of Peterson Detention and principal shareholders of Peterson Detention, and Argyle and ISI were signatory to the Asset Purchase Agreement for certain limited purposes. Peterson Detention is engaged in the business of manufacturing and selling steel products.

In consideration for the sale of its assets to ISI-Detention, Peterson Detention will receive cash in the amount of $1,500,000 and convertible promissory notes (the “Promissory Notes”) in the aggregate principal amount of $3,000,000. The aggregate principal amount of the Promissory Notes may be reduced depending on the occurrence of certain events described in the Asset Purchase Agreement. The Promissory Notes will bear interest at the rate of 6% per year and will become due and payable on December 31, 2012. Events of default under the Promissory Notes consist of the failure to pay, bankruptcy or insolvency. On February 28, 2008 the holders of the Promissory Notes may convert up to $1,500,000 of the outstanding balance of the Promissory Notes into shares of Argyle’s common stock at the average closing price of Argyle’s common stock for the 20 trading days preceding the conversion date, provided that the conversion price may be no less than $8.00 per share. At any time on or after June 1, 2009, but before November 15, 2009, ISI-Detention may, in its sole discretion, require the holders of the Promissory Notes to choose one of the following options: (i) the conversion of an aggregate of $500,000 of the outstanding principal amounts of the Promissory Notes into Argyle’s common stock at 95% of the average closing price of Argyle’s common stock for the 20 trading days preceding delivery of the election notice; or (ii) ISI Detention’s payment to Holder of an aggregate of $7,500 in exchange for which the payment schedule of the Promissory Notes will be amended such that $500,000 of the principal due in 2010 will be due and payable on January 3, 2011, with interest continuing to accrue on all unpaid principal amounts. The payment of the Promissory Notes is guaranteed by Argyle, ISI and ISI Detention Contracting Group, Inc. a Texas corporation and wholly owned subsidiary of ISI.

Pursuant to the Asset Purchase Agreement, ISI-Detention entered into employment agreements (the “Employment Agreements”) with each of Michael Peterson and Leonard Peterson, pursuant to which each of them will receive a salary of $291,000 per year for services to ISI-Detention as General Manager and Operations Manager, respectively. Each would also be entitled to receive a bonus and benefits in accordance with ISI-Detention’s policies. The term of each Employment Agreement is three years, after which employment will become at-will. In the event of a termination without cause, ISI-Detention would be required to pay each executive his full compensation for 18 months or until the term of the Employment Agreements was set to expire, whichever was earlier.

Other Events Related to Acquisitions or Disposal of Assets

On January 3, 2008, MCFSA, Ltd. (“MCFSA”), all of the partnership interests of which are directly or indirectly wholly owned by ISI, entered into an Asset Purchase Agreement (the “Asset Purchase Agreement”) with Fire Quest, Inc. (“Fire Quest”) and William L. Calvin, a shareholder of Fire Quest, effective January 1, 2008, pursuant to which MCFSA acquired substantially all of the business assets and liabilities of Fire Quest. Fire Quest is engaged in the business of alarm system sales and service.

In consideration for the sale of its assets to MCFSA, Fire Quest will receive cash in the amount of $750,000 and a promissory note in the aggregate principal amount of $250,000 (“Fire Quest Promissory Note”). The aggregate principal amount of the Fire Quest Promissory Note may be increased or reduced depending on the occurrence of certain events described in the Asset Purchase Agreement. The Promissory Notes will bear interest at the rate of 7.25% per year and will become due and payable on January 1, 2009. Events of default under the Promissory Notes consist of the failure to pay, bankruptcy or insolvency.

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

Forward Looking Statements

This Quarterly Report on Form 10-Q/A 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 unaudited Financial Statements and related Notes thereto included elsewhere in this report.

Overview

Argyle Security Acquisition Corporation (the “Company” or “Argyle”) is a Delaware corporation incorporated on June 22, 2005 in order to serve as a vehicle for the acquisition of an operating business through a merger, capital stock exchange, asset acquisition or other similar business combination with a company in the security industry.

On December 8, 2006, Argyle, Argyle’s wholly-owned subsidiary ISI Security Group, Inc. (the "Merger Subsidiary") and ISI Detention Contracting Group, Inc. (“ISI”) entered into a merger agreement, as amended on June 29, 2007 and July 11, 2007, pursuant to which the Merger Subsidiary would merge into ISI and ISI would become a wholly-owned subsidiary of Argyle.

On July 30, 2007, the stockholders of the Company approved the Company's acquisition of ISI. Stockholders also approved (i) an amendment to the Company's Certificate of Incorporation to change its name to "Argyle Security, Inc.," (ii) the Company's 2007 Omnibus Incentive Compensation Plan, and (iii) an amendment to the Company’s certificate of incorporation to remove certain provisions from the certificate that were no longer applicable after the business combination was consummated.

On July 31, 2007, pursuant to the terms of the merger agreement, the Company acquired all of the assets and liabilities of ISI through the merger of its Merger Subsidiary into ISI. As a result of the merger, ISI became a wholly-owned subsidiary of the Company. Prior to the acquisition of ISI, Argyle had no operations and was considered a developmental stage enterprise. ISI is deemed to be a “predecessor” to the Company. The accompanying unaudited consolidated financial statements include the results of operations for ISI from August 1, 2007 to September 30, 2007.

ISI is a provider of security solutions to commercial, governmental, and correctional customers and specializes in turnkey installations, including design, engineering, supply, and the installation of various security-related equipment. As a security solutions provider, ISI has the ability to interview a customer that needs security for a project and determine that customer’s needs in light of the products and technology available within the customer’s budget. ISI, using its expertise in the security industry, then develops security systems that answer the customer’s needs using hardware and software that is available in the marketplace from third party vendors, as well as its own proprietary software. The work is performed under fixed-price contracts. The length of the contracts varies but is typically less than two years.

ISI participates in the perimeter security, access control and video and design consultation segments in the correctional sector through its ISI-Detention and MCS-Detention subsidiaries and in the commercial / industrial / educational sectors through its MCS-Commercial subsidiary. ISI 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.

Under the purchase method of accounting, the total purchase price is allocated to the net tangible and intangible assets acquired and liabilities assumed, based on various estimates of their respective fair values. We have engaged a third party appraiser to assist us in performing a valuation of ISI's assets and liabilities in accordance with SFAS No. 141. The depreciation and amortization expense adjustments are based on preliminary valuation estimates of ISI's tangible and intangible assets described in Note 4 to the unaudited consolidated financial statements. The final valuation, and any interim updated preliminary valuation estimates, may differ materially from these preliminary valuation estimates and, as a result, the final allocation of the purchase price may result in reclassifications of the allocated amounts that are materially different from the purchase price allocations reflected herein. Any material change in the valuation estimates and related allocation of the purchase price could materially impact our depreciation and amortization expenses and our actual and pro forma results of operations. The accompanying unaudited consolidated statements of operations reflect the operating results of ISI since August 1, 2007.

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, the allowance for doubtful accounts, inventories and related reserves, long-lived assets, investments and income taxes. We base our estimates and assumptions on historical experience, knowledge of current conditions and our understanding of what we believe to be reasonable that might occur in the future considering available information. Actual results may differ from these estimates, and material effects on our operating results and financial position may result.

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

Construction Contracts:

1. 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.

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

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

4. 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 differs, then adjustments are made. If the costs are in excess of the estimate used in the prior month, then a decrease in the percentage complete on the project through the current month in the accounting period is made. If the costs are less than the estimate used in the prior accounting period, then the new estimate increases the percentage complete on the project.

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

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

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

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

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

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

IBNR Estimates for Health Insurance - On an annual basis, the Company estimates its health insurance cost, for its self insured employee base at the acquired company 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 our demographics and prior claim history. The Company uses the average claims history for the trailing the twelve months as its basis for accruing health care cost. This accrual is automated and is part of the payroll function for each pay period.

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

Allowance for Doubtful Accounts - Argyle provides an allowance for bad debt through an analysis in which the bad debts that had been written off over a trailing five year period are compared on a percentage basis to the aggregate sales for the same period. The resulting percentage is applied to the sales for year to date and a monthly reserve is accrued accordingly. Additionally, management analyzes specific customer accounts receivable for any potentially uncollectible accounts and will add such accounts to the reserve or write them off if warranted, after considering lien and bond rights, and then considers the adequacy of the remaining unallocated reserve compared to the remaining accounts receivable balance (net of specific doubtful accounts).