

TRI-S SECURITY CORP  
Form 10-K  
March 31, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

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

For the fiscal year ended December 31, 2007

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-51148

**Tri-S Security Corporation**

(Exact Name of Registrant as Specified in Its Charter)

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

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

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

(Address of Principal Executive Offices)

**(678) 808-1540**

(Registrant's Telephone Number, Including Area Code)

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

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

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

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

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

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

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

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

(Do not check if a smaller reporting company)

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

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The aggregate market value of the voting and non-voting common equity held by non-affiliates completed by reference to the price at which the common equity was last sold as of the last business day of the registrant's most recently completed second fiscal quarter is \$6,981,505.

As of March 26, 2008, 4,203,280 shares of common stock were outstanding.

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

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Annual Report

on

Form 10-K

For the Year Ended December 31, 2007

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**PART I**

**Note Regarding Forward-Looking Statements**

Tri-S Security Corporation, a Georgia corporation ( "Tri-S Security" ), and its subsidiaries (together, the "Company" or "we" ) have made forward-looking statements in this Annual Report on Form 10-K for the year ended December 31, 2007 (the "Annual Report" ), including, without limitation, in the sections herein titled

Management's Discussion and Analysis of Financial Condition and Results of Operations and Business, that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts. Words such as believes, expects, anticipates, intends, seeks, could, will, predicts, potential, continue, may, plans, estimates, expressions, or the negative of these and similar expressions, are intended to identify such forward-looking statements.

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

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

**Item 1. Business Overview**

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

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

Tri-S Security was incorporated in Georgia in October 2001 under the name Diversified Security Corporation and changed its name to Tri-S Security Corporation in August 2004. We were formed for the purpose of acquiring and consolidating electronic and physical security companies in order to take advantage of the operating efficiencies created by a larger company. Our acquisition strategy involves the acquisition and integration of complementary businesses in order to increase our scale within certain geographic areas and capture market share in the markets in which we operate and improve our profitability. We may pursue acquisition opportunities in the contract guard services and system

integration services

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segments of the security industry. We frequently evaluate acquisition opportunities and, at any given time, may be in various stages of due diligence or preliminary discussions with respect to a number of potential acquisitions. From time to time, we may enter into non-binding letters of intent, but we are not currently subject to any definitive agreement with respect to any acquisition material to our operations or otherwise so far advanced in any discussions as to make an acquisition material to our operations reasonably certain. During 2007, we did not pursue acquisitions as aggressively as in the past because we were focused on the integration of the companies previously acquired. In the future, we plan to resume our acquisition plan if opportunities are available.

We made our first acquisition on February 27, 2004, when we acquired all of the outstanding capital stock of Paragon Systems, a contract guard services and logistics provider for a purchase price of \$16,000,000 (the Paragon Acquisition). At the closing of the Paragon Acquisition, we: (i) paid \$10 million, of which \$2.3 million was paid in cash and \$7.7 million was paid through issuance of promissory notes to the former shareholders of Paragon Systems (the Paragon Notes); and (ii) issued to the former shareholders an aggregate of 100 shares of our Series C Redeemable Preferred Stock, with an aggregate redemption value of \$6.0 million (the Series C Redeemable Preferred Stock), payable no later than February 27, 2007. Our payment obligations under the Series C Redeemable Preferred Stock were secured by a pledge of 40% of the outstanding capital stock of Paragon Systems. On February 27, 2006, we filed a lawsuit against the former shareholders of Paragon Systems alleging, among other things, that they breached certain representations made by them in the Stock Purchase Agreement between us and the former shareholders dated as of February 23, 2004, pursuant to which we acquired Paragon Systems (the Paragon Purchase Agreement). On September 13, 2007, the Company entered into a Settlement Agreement between the company, Paragon Systems and Ronald G. Farrell, the Company's Chief Executive Officer and the former shareholders of Paragon Systems (the Selling Shareholders) of Paragon Systems with respect to all of the litigation pending among such parties (the Litigation). See the section of this Annual Report entitled Legal Proceedings for further discussion of the Settlement Agreement.

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

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

We made our second acquisition on October 18, 2005, when we acquired all of the outstanding capital stock of Cornwall, a provider of security and investigative services, including armed and unarmed uniform guards, video and alarm monitoring, alarm installation, and GPS monitoring, to government and private sector customers in the Miami, Florida area (the Cornwall Acquisition). Cornwall has nine wholly-owned subsidiaries: International Monitoring, Inc.; Protection Technologies Corporation; Vanguard Security, Inc.; Armor Security, Inc.; Forestville Corporation; Vanguard of Broward County, Inc.; On Guard Security and Investigations, Inc., Guardsource Corp. and Virtual Guard Service, Inc. At the closing of the Cornwall Acquisition, we paid a total purchase price of \$13,500,000 payable as follows: (i) payment of \$12,825,000 in cash; (ii) delivery of a promissory note in principal amount of \$250,000 payable to the former Cornwall shareholders (the Cornwall Promissory Note); and (iii) deposit of \$425,000 with an escrow agent to secure the indemnification obligations of the former Cornwall shareholders under the Stock Purchase Agreement between us and the former Cornwall shareholders dated as of August 11, 2005 (the Cornwall Purchase Agreement). After adjusting for certain working capital items, the net purchase price was \$12,753,000. On January 26, 2007, we entered into a Settlement Agreement and General Release (the Cornwall Settlement Agreement) with David Shopay, on behalf of himself and the other former shareholders of Cornwall, in his capacity as the representative of such shareholders. Pursuant to the Cornwall Settlement Agreement (i) the parties waived and released each other from all claims and liabilities, with the exception of certain claims and liabilities specified in the Cornwall Settlement Agreement, arising from the Cornwall Purchase Agreement; (ii) the shareholder representative forgave and discharged all amounts owed by us to the former shareholders of Cornwall under the Cornwall Promissory Note; and (iii) the shareholder representative and the Company instructed the escrow agent administering the escrow fund to release \$200,000 from such fund to us and the remaining balance of such fund to the former shareholders of Cornwall.





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

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

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

**Our Contract Guard Services Operations**

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

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

*Paragon Systems*

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

In 1991, Paragon Systems applied to be certified as an 8(a) firm (a small and disadvantaged business) by the SBA. In 1993, Paragon Systems was certified as an 8(a) firm and, in 1994, was awarded its first guard contract to provide security guard services for the U.S. Army Corps of Engineers. Since such time, Paragon Systems has obtained contracts with various other Federal government agencies and has developed contract guard security services as its core business. Paragon Systems certification as an 8(a) firm expired in September 2002, and its revenues from its security guard service business have grown to a level which makes it ineligible to qualify once again for certification as an 8(a) firm. Paragon Systems is now expanding its security guard service business by bidding on larger contracts than it was first awarded when certified as an 8(a) firm.

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

Through Paragon Systems and Southeastern Paragon, we employ approximately 1,100 persons in the course of providing contract guard services and maintain field offices located in Alabama, Kentucky, Maryland, Mississippi, Washington, Pennsylvania, New York, Louisiana, Oregon, California, South Carolina and Washington, DC. Paragon Systems moved its Huntsville, Alabama offices to Chantilly, Virginia in December 2005. A full staff supports the majority of field operations in the Chantilly, Virginia office, including human resources, accounting, payroll, quality control, logistics, computer services, training, and other supporting functions as needed. Accounts payable support is now managed in Tri-S Security s headquarters in Alpharetta, Georgia.



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

<b>Annual Revenues</b>	<b>Year Ended December 31, 2007</b>	<b>Year Ended December 31, 2006</b>	<b>Year Ended December 31, 2005</b>
Less Than \$1.0 Million per Contract	4	8	4
\$1.0 to \$3.0 Million per Contract	7	4	3
Greater than \$3.0 Million per Contract	7	4	5

On December 31, 2007, 16 contracts were active. At December 31, 2007, SEP was serving 2 Federal contracts with aggregate annual contract revenue of approximately \$5.6 million.

*Cornwall*

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

Cornwall offers comprehensive, state-of-the-art customized electronic and manned security systems for commercial, residential and government outlets. Cornwall provides armed and unarmed uniformed security services as well as video, and investigative services to a variety of customers. In addition, Cornwall provides security system integration products (security systems which combine the features of security products) to its customers. Cornwall's communication systems leverage specialized software in order to improve overall security system performance. In response to client needs, Cornwall can combine these integrated security systems with trained professional security guards in order to provide a higher level of security.

Cornwall was incorporated in 1980 and today employs approximately 1,500 employees in five offices throughout the Miami/Dade, Broward and Palm Beach counties of Florida. Each of Cornwall's security professionals undergo extensive training, and many have prior military or government training.

**Our Equity Interest in Army Fleet Support, LLC**

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

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

**Sales and Marketing**

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

**Employees**

As of December 31, 2007, we employed approximately 2,600 people, consisting of security guards, managerial and administrative employees. Our business is labor intensive and, as a result, is affected by the availability of qualified personnel and the cost of labor. Although the contract guard services industry is characterized by high turnover, we believe our experience compares favorably with that of the industry. We have not experienced any material difficulty in employing suitable numbers of qualified security guards, although when labor has been in short supply, we have been required to pay higher wages and incur overtime charges.

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

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

Unionized employees account for approximately 19% of our employees and work under collective bargaining agreements with the United Union of Security Guards, United Government Security Officers of America, United Federation of Special Police & Security Officers and the Security Police and Fire Professionals of America. These collective bargaining agreements do not permit work stoppages. Our relations with our employees have generally been satisfactory. Guards and other personnel supplied by us to its customers are our employees, even though they may be stationed regularly at the customer's premises.

**Insurance**

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

**Customers**

Since the Cornwall Acquisition, we have provided our contract guard services to customers in 13 states and Washington, DC. We provide contract guard services for the following Federal government agencies: (i) the Department of Homeland Security; (ii) the Social Security Administration; (iii) the Army Corps of Engineers; (iv) the U.S. Coast Guard; (v) the National Park Service; and (vi) the Department of Defense. We also provide contract guard services to the following state and local government agencies and private sector organizations: (a) Miami/Dade local government (municipal government); (b) Florida Department of Transportation; (c) Exxon Mobile; and (d) The University of Miami.

Our typical customer contract may provide for an hourly or monthly billing rate used for all security guards at a site or variable hourly billing rates for different guards. Our contracts are usually multi-year contracts with renewal options. For the year ended December 31, 2007, 6 contracts represented more than 48% of our revenues as follows:

General Services Administration ( GSA ) (Miami/Dade County)	14%
Social Security Administration ( SSA ) (Baltimore)	13%
Department of Homeland Security ( DHS ) Washington, DC	8%
GSA (Kentucky)	5%
SSA Metro West Complex (Baltimore)	4%
GSA (Alabama)	4%

**Competition in Contract Guard Services**

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

In the bidding process for our Federal government contracts, there may be 30 bidders or more. However, typically only 5 or 6 bidders have the technical qualifications as established by the government agency's request for proposal. In the bidding process for our private sector contracts, there are typically five to seven other bidders. In each bidding process, we compete primarily on price, the quality of our service and our history of providing contract guard services in the southeastern portion of the United States for over a decade.



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

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

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

### **Government Regulation**

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

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

### **The Security Industry**

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

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

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

#### *Contract Guard Service*

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

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



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#### **Our Strategy**

##### *Operations*

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

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

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

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

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

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

##### *Federal Government Contracts*

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

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

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

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

We currently have bids outstanding on Federal government contracts for contract guard services valued at an aggregate amount of over \$300 million over the next five-years. In addition, we have been solicited to bid on contracts valued at an aggregate amount of approximately \$300 million over the next five years. Our ability to bid on larger contracts is constrained because we do not currently have sufficient capital to cover the substantial start-up costs we would incur if awarded a significant number of contracts with higher values.

##### *Private Sector Contracts*

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

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

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

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

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

*Acquisitions*

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

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

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

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

**Item 1A. Risk Factors**

**Risks Relating to Our Indebtedness and Litigation**

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

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

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

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Pursuant to the Loan and Security Agreement, at our request, LSQ shall make advances ( Advances ) to us not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable through March 31, 2008 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of (i) billed accounts receivable at a

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rate equal to the Prime Rate plus 1% and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5%. In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%.

Under the Credit Agreement Supplement, anytime the 2007 Term Loan is outstanding and so long as unbilled accounts receivable are included in the borrowing base for purposes of making Advances, we must pay a monthly fee to our Lenders equal to 2.25% of the highest daily overadvance amount, which is the highest daily amount in any given month calculated as follows: the outstanding 2007 Term Loan, plus all outstanding Advances less the borrowing base.

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

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2007 is approximately \$14.1 million. Additionally, from time to time during 2007, we have borrowed more than the maximum amount allowable under the availability formula in both the Amended and Restated Credit Agreement and the Original Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, The Company was not in compliance with the Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, the Company and its subsidiaries entered into an Amendment and Forbearance Agreement (the Agreement ) with the Lenders. Pursuant to the Agreement, the Lenders waived certain specified defaults under the Company's credit agreement with the Lenders and agreed to forebear from exercising all remedies available to the Lenders in connection with such existing defaults until the earlier of a potential equity or subordinated debt offering or January 1, 2009.

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

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

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

***We have substantial debt.***

As of December 31, 2007, we had approximately \$23.1 million of outstanding debt (excluding obligations to trade creditors and taxing authorities including the IRS). We may incur substantial additional debt in the future, including additional debt under the Loan and Security Agreement. It will be difficult for us to satisfy our payment obligations. Our considerable indebtedness could have important consequences to you, including, but not limited to, the following:

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

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

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

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

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

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

interest rates and general economic conditions;

competitive conditions in our industry;

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

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

delays or difficulties in implementing our business strategies.

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

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

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

incur or guarantee additional indebtedness;

pay dividends and make distributions;

make certain investments;

repurchase stock;



incur liens;

enter into certain transactions with affiliates;

enter into sale and leaseback transactions;

merge or consolidate; and

transfer or sell assets.

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

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

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

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*We have a state income tax liability of \$0.5 million for the 2006 tax year which we may be unable to pay due to liquidity issues.*

As of December 31, 2007, we have a state income tax liability of approximately \$0.5 million, including accrued penalties and interest, owed to the State of Alabama. In order to pay the State of Alabama and satisfy the obligation, we will be required to draw upon our debt facilities. We may be unable to pay our tax liability in the ordinary course because (i) we may not have the availability under our credit facility to make the payment or (ii) our Lenders may be unwilling to advance the funds under our credit facility to make the payment.

**Risks Relating to Our Industry and Business**

*We depend on the Amended and Restated Credit Agreement to meet our cash flow needs, which reduces our profit margin.*

Pursuant to the Loan and Security Agreement, our Lenders shall make advances not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable through March 31, 2008 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of (i) billed accounts receivable at a rate equal to the Prime Rate plus 1.0% and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5%. In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%. This discount and usage fee reduces our profit margins. We cannot, however, cease financing our receivables because the funds provided by our Lenders are necessary to satisfy our cash flow needs. In fact, we utilize the Amended and Restated Credit Agreement to allow us to finance substantially all of our accounts receivable. We believe that if the Amended and Restated Credit Agreement with our Lenders were to terminate, then we would need to obtain a new credit agreement. Our obligations to our Lenders are secured by a lien on all of our assets; consequently, if we are liquidated, then there may not be any assets available for distribution to shareholders or creditors other than our Lenders.

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

Our largest expenses are payroll, payroll taxes and employee related benefits. Most of our service contracts provide for a fixed hourly bill rate, and some of our service contracts provide for payments of either fixed fees or fees that increase by only small amounts during the terms of such service contracts or not at all. Competitive pressures also may prevent us from raising our fees or hourly bill rates when contracts are renewed. If, due to inflation or other causes, including increases in statutory payroll taxes, we must increase the wages, salaries and related taxes and benefits of our employees at rates faster than we can increase the fees charged under our service contracts, then our profitability will be adversely affected.

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

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

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

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

Turnover of contract security guards is significant. The loss of the services of, or the failure to recruit, a significant number of skilled security guards and administrative staff would have a materially adverse affect on our business, financial condition and results of operations, including

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our ability to secure and complete service contracts. Furthermore, if we do not successfully manage our existing security guards and administrative staff, we may not be able to achieve the anticipated billing rates, engagement quality, level of overtime and other performance measures that are important to our business, financial condition and results of operations.

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

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

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

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

The contract security guard services industry is intensely competitive. We directly compete with companies that are national and international in scope, and some of our competitors have significantly greater personnel, financial, technical and marketing resources than we do, generate greater revenues than we do and have greater name recognition than we do. The recent trend toward consolidation in our industry will likely lead to increased competition from these companies. We also compete with smaller local and regional companies that may have better knowledge of the local conditions in their regions, are better known locally and are better able to gain customers in their regions. There are relatively low barriers to entry into the contract security guard services industry, and we have faced and expect to continue to face additional competition from new entrants into the contract security guard services industry. In addition, some of our competitors may be willing to provide services at lower prices, accept a lower profit margin or expend more capital in order to obtain or retain business. If we cannot successfully compete with new or existing security service providers, then our business, financial condition and results of operations will be adversely affected.

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

successfully merge corporate cultures and operational and financial systems;

integrate and retain the customer base of the acquired business;

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

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

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

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

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

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

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

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

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

***Compliance with the corporate governance requirements to which we are subject as a public corporation will cause us to incur significant costs, and the failure to comply with such requirements will expose us to investigations and sanctions by regulatory authorities.***

We face corporate governance requirements under the Sarbanes-Oxley Act of 2002 ( Sarbanes-Oxley ), as well as new rules and regulations subsequently adopted by the SEC, the Public Corporation Accounting Oversight Board and The Nasdaq Stock Market, LLC. (the Nasdaq ). In particular, we will be required to include a management report on internal control as part of our annual report for the year ending December 31, 2007 pursuant to Section 404 of Sarbanes-Oxley. Although we believe we have adequate internal control procedures in place, we are in the process of evaluating our internal controls systems in order (i) to allow management to report on our internal controls, as required by these laws, rules and regulations, (ii) to provide reasonable assurance that our public disclosure will be accurate and complete and (iii) to help ensure that we will be able to comply with the other provisions of Section 404 of Sarbanes-Oxley. We cannot be certain as to the timing of the completion of our evaluation, testing and remediation actions or the impact of the same on our operations. If we are not able to implement the requirements relating to internal controls and all other provisions of Section 404 in a timely fashion or otherwise achieve adequate compliance with such requirements, then we might be subject to sanctions or investigation by regulatory authorities, such as the SEC or the Nasdaq. Any such action may materially adversely affect our reputation, financial condition and the value of our securities, including the common stock. In addition, we expect that these laws, rules and regulations will increase our legal and financial compliance costs and make certain corporate governance activities more difficult, time-consuming and costly. We also expect that these new requirements will make it more difficult and expensive for us to maintain director and officer liability insurance.

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

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



existing customers and, therefore, would adversely affect our revenues.

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

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

**Risks Related to Government Contracting**

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

During 2007, we derived approximately 55% of our consolidated revenue from contracts with the Federal government. Federal government contracts typically span one or more base years and one or more option years. The option periods may cover more than half of the contract's potential duration. Federal government agencies generally have the right not to exercise these option periods. In addition, our contracts typically also contain provisions permitting a government customer to terminate the contract for its convenience, as well as for our default. A decision by a government agency not to exercise option periods or to terminate contracts could result in significant revenue shortfalls.

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

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

During 2008, we expect to derive approximately 60% of our consolidated revenue from contracts with Federal government agencies. If any of our current Federal government customers determines not to renew or terminate its contract, then our revenues may significantly decline.

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

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

reduce or modify its contracts or subcontracts;

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

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

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

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

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

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

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

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

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

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

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

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

The GSA secures the buildings, products, services, technology and other workplace essentials which Federal agencies need to operate. GSA Federal Supply Schedule Contracts are contract vehicles under which Federal government agencies may purchase professional services or products. Federal government agencies may choose to award contracts only to GSA Federal Supply Schedule Contractors to reduce the number of qualified bidders and to expedite the bidding process. Paragon Systems has been approved by the GSA as a GSA Federal Supply Schedule Contractor and, therefore, is able to bid on Federal government contracts awarded using the GSA Federal Supply Schedule. Currently, six of our contracts with annualized revenues of approximately \$25 million have been procured under the GSA Federal Supply Schedule. During the year ended December 31, 2007, the revenues on our contracts procured under the GSA Federal Supply Schedule totaled approximately 24% of our consolidated revenues for such period.

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

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

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

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

During the year ended December 31, 2007, of our revenue derived from federal contracts, substantially all was awarded through a competitive bidding process. Most of the business that we expect to seek from the Federal government in the foreseeable future likely will be awarded through competitive bidding. Competitive bidding presents a number of risks, including:

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

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

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

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

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

***The Miami/Dade County contracts at Cornwall represent a significant portion of our revenue***

During the year ended December 31, 2007, two of Cornwall's subsidiaries generated revenue from contracts with Miami/Dade County of \$12.2 million. The Board of County Commissioners of Miami/Dade County has extended all contracts through September 30, 2008. After that date, the contract may be subject to rebid.

The bid process will be based on a number of factors including price and experience in providing the specific security services called for in the bid process. Competitive bidding represents a number of risks including:

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

the requirement to post a bid bond in order to participate in the bidding process and a performance bond if we win the bid. The bonding requirement may require us to provide a letter of credit or other collateral to the bonding company which may be problematic given our financial condition.

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

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

The failure to win Miami/Dade County contracts will significantly reduce the revenue and profits of the Cornwall Group and our business, financial condition and the results of operations will be materially and adversely affected.

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

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

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

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

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

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

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

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

**Risks Relating to Our Securities**

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

Management owns or controls shares of the common stock which shares represent approximately 37% of the combined voting power of our outstanding capital stock. Management has the power to influence the election of our directors and all decisions made by our shareholders and, in general, to influence the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets. The interests of management may conflict with the interests of our other shareholders.

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

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



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

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

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

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

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

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

announcements of competitive developments by us or others;

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

any loss by us of a major customer;

additions or departures of key management or other personnel;

our failure to meet financial analysts' performance expectations;

guidance we provide;

future sales of the common stock or preferred stock;

volume fluctuations;

acquisitions or strategic alliances by us or our competitors;

our historical and anticipated operating results;

quarterly fluctuations in our financial and operating results;

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

general market and economic conditions.

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

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

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

## **Item 2. Properties**

Our corporate headquarters and principal executive offices are located in Alpharetta, Georgia, and our contract guard services operations are located at the offices of our wholly-owned subsidiaries, Paragon Systems and Cornwall, in Chantilly, Virginia and Miami, Florida, respectively. We lease space at each of the foregoing locations. We are obligated to pay rent on the (i) Alpharetta, Georgia facility of approximately \$4,530 per month through November 2008; (ii) Chantilly, Virginia facility of approximately \$8,120 per month, with 4% annual increases, through November 2011; and (iii) the Miami, Florida facility of approximately \$7,259 per month through April 2008.

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

## **Item 3. Legal Proceedings**

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

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**Litigation with the Former Shareholders of Paragon Systems**

On September 13, 2007, Tri-S Security entered into a the Settlement Agreement, among Tri-S Security, Paragon Systems and Ronald G. Farrell, Tri-S Security's Chief Executive Officer, on the one hand, and the Selling Shareholders of Paragon Systems, on the other hand, with respect to all of the Litigation pending among such parties (the Settlement Agreement). Pursuant to the Settlement Agreement:

- (i) Tri-S Security paid the Selling Shareholders an aggregate of \$1,250,000;
- (ii) the Selling Shareholders and Tri-S Security cancelled the shares of its Series C Redeemable Preferred Stock held by the Selling Shareholders, which shares had an aggregate redemption value of \$6,000,000;
- (iii) the Selling Shareholders terminated and released their security interest in the outstanding shares of capital stock of Paragon Systems;
- (iv) Tri-S Security issued to the Selling Shareholders an aggregate of 700,000 shares of its common stock and an aggregate of 100 shares of its newly-designated Series D Redeemable Preferred Stock, which shares (a) have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012 or the date on which Tri-S Security sells 70% or more of its assets in one or more transactions (unless the proceeds from such sale are reinvested in Tri-S Security's business, used to restructure debt or used for acquisitions or working capital purposes) and (b) accrue dividends of \$750 per share per annum, payable quarterly;
- (v) Tri-S Security agreed not to amend Mr. Farrell's employment agreement to increase or enhance the compensation or benefits payable to him thereunder until September 13, 2008;
- (vi) Tri-S Security agreed to issue to the Selling Shareholders an aggregate of 10% of any equity securities of the Company which are issued to Mr. Farrell during the period commencing on May 18, 2007 and ending on May 18, 2008;
- (vii) the Selling Shareholders, pursuant to a Voting Agreement, granted to Mr. Farrell a proxy to vote, in his sole and absolute discretion, an aggregate of 700,000 shares of common stock held by the Selling Shareholders until such time as such shares are sold by them to an unaffiliated party in accordance with the terms of the Securities Act of 1933, as amended (the Securities Act);
- (viii) Tri-S Security agreed to indemnify the Selling Shareholders for costs and expenses incurred by them relating to the litigation pending against Tri-S Security in the United States District Court for the Northern District of Georgia regarding Tri-S Security's initial public offering; and
- (ix) Tri-S Security, Paragon Systems and the Selling Shareholders released each other from all claims and obligations among them existing as of September 13, 2007 (except for obligations arising pursuant to the terms of the Settlement Agreement) and caused the Litigation to be dismissed with prejudice.

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

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**Table of Contents****Index to Financial Statements****Litigation Regarding Our Initial Public Offering and Related Insurance Coverage**

On November 1, 2006, a purported class action complaint was filed in the State Court of Fulton County, State of Georgia, against Tri-S Security, its Chief Executive Officer, its former Chief Financial Officer and the lead underwriters in Tri-S Security's initial public offering, alleging, among other things, violations of Sections 11, 12(a)(2) and 15 of the Securities Act in connection with Tri-S Security's initial public offering (*Unschuld v. Tri-S Security Corp., et al.*, the Unschuld Litigation). More specifically, the complaint alleges that the registration statement relating to the initial public offering was materially inaccurate and misleading because it failed to disclose certain problems with the operations and financial condition of Paragon Systems of which the complaint alleges we were aware. The complaint seeks class certification, unspecified compensatory damages or rescission, as appropriate, and costs and disbursements relating to the lawsuit, including reasonable attorneys' fees. On December 1, 2006, Tri-S Security removed the lawsuit to the United States District Court for the Northern District of Georgia. Plaintiff moved to remand the case back to the state court, which motion was granted on September 14, 2007, and the case is now pending in the State Court of Fulton County, State of Georgia. The deadline for Tri-S Security to respond to the Complaint is March 21, 2008, but the parties have agreed to extend that deadline to April 21, 2008. The Company intends to vigorously defend the action and believes it has meritorious defenses to the allegations.

On December 10, 2007, Tri-S Security filed an action in the Superior Court of Fulton County, State of Georgia, against Axis Reinsurance Company and Axis Insurance Company (Axis) for declaratory and injunctive relief. Axis issued a Directors, Officers, and Corporate Liability Insurance Policy to Tri-S Security for the period from March 13, 2006 to March 13, 2007 (the Axis Policy). Tri-S Security provided notice of the Unschuld Litigation to Axis on November 8, 2006. On November 9, 2007, attorneys for Axis informed Tri-S Security that Axis disclaimed coverage for the Unschuld Litigation. Tri-S Security seeks (i) a declaratory judgment that coverage for the Unschuld Litigation is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems and that Axis is required to advance defense costs incurred in connection with the Unschuld Litigation and (ii) an order requiring Axis to advance such defense costs.

On March 13, 2008, Tri-S Security filed an action in the Superior Court of Fulton County, State of Georgia, against Capitol Specialty Insurance Corporation (Capitol), McGriff, Seibels & Williams of Georgia, Inc. and McGriff, Seibels & Williams, Inc. (collectively, McGriff), seeking declaratory relief and damages. McGriff acted as Tri-S Security's broker in obtaining the Axis Policy. Capitol issued a Directors and Officers Liability Insurance Policy to Tri-S for the period from February 9, 2005 to March 13, 2006 (the Capitol Policy). Tri-S Security provided notice under the Capitol Policy of the Unschuld Litigation on December 13, 2007. Coverage under that policy was denied on January 25, 2008. In the event that the Unschuld Litigation is not covered under the Axis Policy, Tri-S Security is seeking (i) a declaration that the Capitol Policy requires Capitol to advance defense costs in connection with the Unschuld Litigation; (ii) an order requiring Capitol to advance such defense costs; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for any such loss. In the event that Tri-S Security is not fully covered under either the Axis Policy or the Capitol Policy in connection with the Unschuld Litigation, Tri-S Security is seeking (a) damages, in an amount to be determined at trial, against McGriff for negligence, breach of contract, negligence per se, negligent procurement, negligent misrepresentation, professional negligence, and breach of fiduciary duty; (b) a declaration that McGriff is required to cover any loss as defined in the Axis Policy that Tri-S Security incurs in connection with the Unschuld Litigation up to the limit of liability of the Axis Policy; and (c) an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation.

**Dispute with Miami-Dade General Services Administration**

A search warrant was issued on January 17, 2008 by the Circuit Court of the eleventh judicial circuit in and for Miami-Dade County, Florida to search the premises of Forestville Security, a subsidiary of Tri-S Security based in Miami for any and all records or documents pertaining to the contract between Forestville Security (Forestville) and Miami-Dade General Services Administration (GSA) for the period of April 1, 2005 to August 1, 2007.

The search warrant states that GSA is alleging that it has uncovered instances of fraudulent billing committed by Forestville in connection with the GSA contract. Forestville is fully cooperating with the authorities regarding the investigation.

The Company believes that it has meritorious defenses to the allegations made and is vigorously defending these proceedings. Accordingly, the Company has not established a litigation reserve.

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

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Our annual meeting of shareholders was held on November 8, 2007, in Alpharetta, Georgia (the Meeting ). At the Meeting, our shareholders voted on proposals to (i) elect one Class II director for a three-year term of office; and (ii) ratify the appointment of Tauber & Balser, P.C. as our independent registered public accountants for the year ended December 31, 2007. Each of the foregoing proposals was approved by our shareholders at the Meeting.

With respect to the proposal to elect one Class II director, there were 3,903,195 votes cast for the election of James A. Verbrugge as the Class II director and 58,619 votes cast to withhold authority with respect to the election of James A. Verbrugge as the Class II director. There were no broker non-votes with respect to the election of Mr. Verbrugge. After the Meeting, James M. Logsdon, Lee K. Toole and Ronald G. Farrell, who serve as Class I, Class III and Class III directors, respectively, continued their respective terms of office as directors of the Company.

With respect to the proposal to ratify the appointment of Tauber & Balser, P.C. as our independent registered public accountant for the year ended December 31, 2007, there were 3,918,414 votes cast in favor, 1,000 votes cast against, 42,400 votes cast to abstain and no broker non-votes.

The proposals presented at the Meeting were set forth and described in our Notice of Annual Meeting of Shareholders and Proxy Statement dated October 11, 2007.

**Table of Contents****Index to Financial Statements****Item 4.5 Executive Officers of the Registrant**

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

The following table sets forth the name of each executive officer of the Company, the office held by such officer and the age, as of March 30, 2008, of such officer:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Ronald G. Farrell	64	Chairman of the Board, President and Chief Executive Officer
Nicolas Chater	54	Chief Financial Officer

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

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

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

There are no family relationships among any of our executive officers or directors. Except as disclosed in the section of this Annual Report titled Executive Compensation, no arrangement or understanding exists between any executive officer and any other person pursuant to which any executive officer was selected to serve as an executive officer. To the best of our knowledge, (i) there are no material proceedings to which any executive officer of the Company is a party, or has a material interest, adverse to the Company; and (ii) there have been no events under any bankruptcy act, no criminal proceedings and no judgments or injunctions that are material to the evaluation of the ability or integrity of any executive officer during the past five years. Our executive officers of the Company are elected or appointed by our board of directors and hold office until their successors are elected and qualified, or until their death, resignation or removal, subject to the terms of applicable employment agreements.

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

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

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

<b>Year Ended December 31, 2007</b>	<b>High</b>	<b>Low</b>
Fourth Quarter of 2007	\$ 2.31	\$ 1.32

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Third Quarter of 2007	\$ 2.78	\$ 1.78
Second Quarter of 2007	\$ 4.05	\$ 2.28
First Quarter of 2007	\$ 2.85	\$ 1.85
<b>Year Ended December 31, 2006</b>	<b>High</b>	<b>Low</b>
Fourth Quarter of 2006	\$ 3.20	\$ 1.85
Third Quarter of 2006	\$ 3.21	\$ 2.20
Second Quarter of 2006	\$ 4.10	\$ 2.61
First Quarter of 2006	\$ 4.62	\$ 2.65



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As of March 26, 2008, there were approximately 16 holders of record of the common stock.

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

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

*The results of operations set forth below for the years ended December 31, 2007, 2006 and 2005 are based on historical results for the Company. The results of Cornwall are included in our consolidated financial statements beginning on October 1, 2005.*

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

**Overview**

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

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

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

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

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

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

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

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



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

**Critical Accounting Policies and Estimates**

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

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

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

Contracts with Federal government agencies may be subject to cessation of funding. Cessation of funding may result in amounts billed and recorded as revenue as being uncollectible. We work with the appropriate government agency to resolve funding issues. When funding issues become known, we make estimates and judgments about the extent of potential losses and adjust revenues accordingly. Amounts estimated could differ from amounts ultimately collected and these amounts could be material. During 2005, 2006 and 2007, none of our contracts have been subject to cessation of funding.

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

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

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

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

**SFAS No. 123(R).** On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123(R) (revised 2004), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. Statement 123(R) supersedes APB Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. The approach to accounting for share-based payments in Statement 123(R) is similar to the approach described in Statement 123.

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However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and no longer allows pro forma disclosure as an alternative to financial statement recognition.

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Effective January 1, 2006, we adopted Statement 123(R) using the modified prospective method and, therefore, reflect compensation expense in accordance with the SFAS 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates. See Note 3 for information on the impact of our adoption of Statement 123R.

**Results of Operations for the Years Ended December 31, 2007, 2006 and 2005**

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

	Change from Year Ended December 31, 2006 to Year Ended December 31, 2007		Change from Year Ended December 31, 2005 to Year Ended December 31, 2006		Change from Year Ended December 31, 2004 to Year Ended December 31, 2005	
	\$	%	\$	%	\$	%
Revenues	\$ 13,218	17.5%	\$ 33,740	80.4%	\$ 11,855	39.3%
Operating expenses:						
Direct labor	(9,328)	(19.7)	(22,947)	(94.0)	(8,115)	(49.8)
Indirect labor and other contract support costs	(5,917)	(30.7)	(5,202)	(37.0)	(1,718)	(13.9)
Selling, general and administrative	312	2.7	(5,549)	(90.5)	(3,788)	(161.5)
Amortization of customer contracts and intangible assets	22	0.9	(1,610)	(168.4)	(658)	(220.8)
Operating loss	(1,693)	(33.0)	(1,568)	(44.0)	(2,424)	(212.6)
Income from investment in Army Fleet Support	(384)	(100.0)	(1,393)	(78.4)	140	8.6
Interest income	(12)	(100.0)	(32)	(72.7)	41	1,366.7
Interest expense	692	22.0	(1,763)	(127.5)	8	0.6
Interest on Series C Redeemable Preferred Stock	89	29.7			(50)	(20.0)
Other income(expense)	(106)	(3.9)	2,921	1,098.1	(266)	N/A
Loss before income taxes	(1,414)	(25.6)	(1,835)	(49.7)	(2,551)	(223.6)

**Table of Contents****Index to Financial Statements***Revenue*

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

Cornwall was acquired by Tri-S on October 18, 2005. The increase in revenue from 2005 to 2006 is primarily the result of the inclusion of Cornwall's revenue for all of 2006 versus only the fourth quarter for 2005, and secondly, the increase in revenue at Paragon Systems and its consolidated subsidiary, SEP, due to three new contracts for each of Paragon Systems and SEP, net of two contract expirations during 2006 for Paragon Systems.

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

<b>Annual Revenues</b>	<b>Year Ended December 31, 2007</b>	<b>Year Ended December 31, 2006</b>	<b>Year Ended December 31, 2005</b>
Less Than \$1.0 Million per Contract	4	8	4
\$1.0 to \$3.0 Million per Contract	7	4	3
Greater than \$3.0 Million per Contract	7	4	5

On December 31, 2007, 16 total contracts were active of which Paragon served 14 and SEP served 2.

The following table sets forth the years in which our contracts existing as of December 31, 2007 will expire:

<b>Number of Contracts</b>	<b>Year Expiring</b>
4	2008
7	2011
4	2012
1	2018

*Costs of Revenues*

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

*Direct Labor.* Direct labor is the most significant expense in providing guard services on any contract. Direct labor was approximately 63.7% of revenue in 2007, 62.5% of revenue in 2006 and 58.1% of revenue in 2005. When bidding on contracts, we must anticipate labor rates during the contract term. The increase in 2007 over 2006 is primarily due to the start up costs and pricing pressure on six new Federal government contracts obtained by Paragon.

*Indirect Labor and Other Contract Support Costs.* This category of expenses consists primarily of indirect labor (guard supervisors), our portion of payroll taxes, employee benefit costs and other expenses. Other expenses comprise a relatively small portion of costs in this category. As with direct labor, when bidding on contracts, we must anticipate the cost of providing supervisory oversight of the guards performing the actual guard services and the related payroll taxes and employee benefits that are provided to both guards and supervisors. Indirect labor and other contract support costs were approximately 28.3% of revenue in 2007, 25.4% of revenue in 2006 and 33.5% of revenue in 2005. The increase in 2007 over 2006 is again due primarily to start up costs on the 6 new Federal government contracts obtained by Paragon. In addition, Cornwall costs increased as a result of higher workers compensation claims of \$0.9M incurred in 2007 over 2006.

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

*Total Cost of Revenue.* Our total cost of revenue was 93.8% of revenue in 2007, 90.1% of revenue in 2006 and 93.2% of revenue in 2005. The decrease in 2006 over 2005 is due to the acquisition of Cornwall in 2005, where the cost of revenue is traditionally lower than in the government sector.



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#### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses as a percentage of revenue was 12.8% in 2007, 15.4% in 2006 and 14.6% in 2005. Selling, general and administrative expenses consist primarily of payroll and related expenses for administrative personnel in our operations offices located in Chantilly, Virginia and Miami, Florida and in our corporate office located in Alpharetta, Georgia. It also includes occupancy costs at the office locations, consulting and professional fees, and certain miscellaneous office and corporation expenses. Selling, general and administrative expenses decreased by approximately \$312,000 from 2006 to 2007. The decrease is due to lower costs at Paragon and Cornwall as a result of lower headcount and related support costs, offset somewhat by higher professional fees related to the implementation of Sarbanes Oxley and higher stock option expense.

#### *Joint Venture*

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

#### *Interest Income and Interest Expense*

The interest expense for 2007 relates to the interest incurred on our Factoring Agreement, our outstanding term loan, our mandatory redeemable Preferred Stock, and the interest expense incurred on our 10% convertible promissory notes.

The interest expense for 2006 relates to the interest incurred on our Factoring Agreement and our outstanding Series C Redeemable Preferred Stock, and the interest expense incurred on our 10% convertible promissory notes. Interest expense was also incurred on two term loans that were repaid in May 2006. Interest expense is lower in 2007 vs. 2006, primarily associated with the payoff of the two term loans in May 2006, and payment of default interest in 2006 not repeated in 2007.

#### *Income Tax Expense*

The income tax benefit for 2007, 2006 and 2005 was \$2.6, \$1.7 and \$1.4 million, respectively, which was 38.0%, 30.6% and 38.4% of the loss before income taxes generated during 2007, 2006 and 2005, respectively.

### **Liquidity and Capital Resources**

As of December 31, 2007, we had \$465,000 of cash on hand. Cash used by operating activities was \$5.9 million for the year ended December 31, 2007. The cash used by operations was primarily due to a net loss during 2007 of \$3.8 million, the increase in unbilled and trade accounts receivable of \$1.2 million at December 31, 2007 as compared to 2006, and the payment made for the Paragon settlement of \$1.3m. Cash provided by financing activities was \$6.5 million primarily due to net proceeds from the factoring facility and term loan of \$6.6 million.

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2007 is approximately \$14.1 million. Additionally, from time to time during 2007, we have borrowed more than the maximum amount allowable under the availability formula in both the Amended and Restated Credit Agreement and the Original Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, The Company was not in compliance with the Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, the Company and its subsidiaries entered into an Amendment and Forbearance Agreement (the Agreement) with the Lenders. Pursuant to the Agreement, the Lenders waived certain specified defaults under the Company's credit agreement with the Lenders and agreed to forebear from exercising all remedies available to the Lenders in connection with such existing defaults until the earlier of a potential equity or subordinated debt offering or January 1, 2009.

The Company has historically incurred losses and has not yet generated sufficient levels of cash flows from operating activities to meet its scheduled debt service payments and other obligations. Additionally, the Company's 10% Convertible Notes with an outstanding principal

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balance of \$7,473,000 mature in September and October of 2008. The Company anticipates that the recently awarded contracts along with the initiatives instituted to maximize cash flows and raise additional equity will alleviate any short-term liquidity issues facing the Company. Management is also evaluating various alternatives to restructure the 10% Convertible Notes which mature later this year. Management believes these initiatives will contribute toward achieving profitability and alleviating the liquidity issues facing the Company.

**Off-Balance Sheet Arrangements**

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

**Income Taxes**

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007. FIN 48

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prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. The adoption of FIN 48 resulted in the recognition of \$32,104 of penalties which was recorded as an adjustment to the January 1, 2007 retained earnings. No adjustments were made during 2007 to the balance of unrecognized tax benefits and no material change is expected in the next twelve months.

**Recent Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS 159 ). SFAS 159 permits many financial instruments and certain other items to be measured at fair value at the option of the Company. Most of the provisions in SFAS 159 are elective; however, the amendment to SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, applies to all entities with available-for-sale and trading securities. The fair value option established by SFAS 159 permits the choice to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for financial statements issued for the first fiscal year beginning after November 15, 2007. Early adoption is permitted provided that the choice be made in the first 120 days of that fiscal year and SFAS No. 157, Fair Value Measurements is also adopted. The Company is currently evaluating the impact, if any, that this new standard will have on the Company's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, that this new standard will have on the Company's results of operations, financial position or cash flows.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to various market risks, including changes in interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and foreign currency exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. We have not entered into financial instruments to manage and reduce the impact of changes in interest rates and foreign currency exchange rates, although we may enter into such transactions in the future.

**Item 8. Financial Statements and Supplementary Data**

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

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

None.

**Item 9A(T). Controls and Procedures**

(a) *Evaluation of disclosure controls and procedures.*

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as amended (the Exchange Act ). In designing and

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evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2007, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is

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recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

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

The management of Tri-S Security is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on management's assessment and those criteria, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2007.

*(c) Changes in internal control over financial reporting.*

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

There were no changes in our internal control over financial reporting that occurred during the fourth quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

On February 2, 2007, the SEC notified us that (i) our Annual Reports on Form 10-K and Form 10-K/A for the years ended December 31, 2005 and 2004, respectively (the Prior Annual Reports), are not in compliance with the requirements of Form 10-K and Regulation S-X and are considered to be materially deficient because such reports do not include the separate financial statements of Army Fleet Support for the applicable years as required by Form 10-K and Regulation S-X; and (ii) this Annual Report will not be in compliance with the requirements of Form 10-K and Regulation S-X unless audited financial statements for Army Fleet Support are included herein for the three years ended December 31, 2006. (Such financial statements are not included in this Annual Report.)

The SEC's notification was made in connection with it denying our request, made on January 29, 2007, that the SEC waive the disclosure requirements of Form 10-K and Regulation S-X with respect to us including the financial statements of Army Fleet Support in our periodic filings. We are unable to include such financial statements in our periodic filings because (i) the financial statements of Army Fleet Support which are required to be so included do not currently exist; (ii) we are unable to prepare them based upon the limited financial information with respect to Army Fleet Support which we received from Army Fleet Support; and (iii) L-3 Communications Corp., the majority owner of Army Fleet Support, has denied us access to the financial information with respect to Army Fleet Support that would be necessary for us to prepare the required financial statements for Army Fleet Support.

Consequently, the Prior Annual Reports and this Annual Report are not in compliance with the requirements of Form 10-K and Regulation S-X. As a result of the foregoing, the SEC will not declare effective any registration statements filed by us, and our securities may not be offered and sold under effective registration statements, subject to certain exceptions.



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PART III.

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

The information required by this Item is incorporated herein by reference to the sections of our proxy statement for our 2008 Annual Meeting of Shareholders (the Proxy Statement ) titled Proposal I: Election of Directors, Section 16(a) Beneficial Ownership Reporting Compliance and Code of Ethics.

**ITEM 11. Executive Compensation**

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

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

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

**ITEM 13. Certain Relationships and Related Transactions and Director Independence**

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

**ITEM 14. Principal Accountant Fees and Services**

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

**ITEM 15. Index to Financial Statements**

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

(1) Index to Consolidated Financial Statements

	<b>Page</b>
Tri-S Security Corporation and Subsidiaries:	
<u>Reports of Independent Registered Public Accounting Firms</u>	F-1
Financial Statements	
<u>Balance Sheets</u>	F-2
<u>Statements of Operations</u>	F-3
<u>Statements of Shareholders' Equity</u>	F-4
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(2) Financial Statement Schedules

(3) Exhibits. The exhibits required to be filed with this Annual Report are listed on the Exhibit Index filed herewith.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors

Tri-S Security Corporation

We have audited the accompanying consolidated balance sheets of Tri-S Security Corporation and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations, shareholders' equity and cash flows for the years ended December 31, 2007, 2006 and 2005. Our audits also included the financial statement schedule listed at Item 15. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tri-S Security Corporation and subsidiaries at December 31, 2007 and 2006, and the results of their operations and cash flows for the years ended December 31, 2007, 2006 and 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respect the information set forth therein.

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

/s/ Tauber & Balsler, P.C.

Atlanta, Georgia  
March 31, 2008

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

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 465	\$ 66
Unbilled revenues and trade accounts receivable, net of allowance for doubtful accounts of \$701 and \$797, respectively	13,993	13,313
Prepaid expenses and other assets	701	649
Total current assets	15,159	14,028
Property and equipment, less accumulated depreciation	476	597
Goodwill	16,078	16,078
Intangibles, net		
Customer contracts	2,647	4,264
Deferred loan cost	515	1,143
Other	769	991
Total assets	\$ 35,644	\$ 37,101
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Trade accounts payable	\$ 1,983	\$ 1,104
Other accrued expenses	895	1,227
Accrued salary and benefits	3,940	3,240
Income taxes payable	586	1,269
Factoring facility	11,625	7,506
10% convertible notes	7,473	
Long term debt - current portion	8	284
Series C preferred stock subject to mandatory redemption		6,000
Total current liabilities	26,510	20,630
Other liabilities:		
10% convertible notes		7,273
Deferred income taxes		1,974
2007 term loan	2,500	
Accrued interest - long term	353	400
Series D preferred stock subject to mandatory redemption	1,500	
Total liabilities	30,863	30,277
Stockholders' equity :		
Common stock, \$0.001 par value, 25,000,000 shares authorized, 4,248,704 and 3,503,280 shares issued	4	3
Treasury stock - 45,424 shares at cost	(105)	(105)

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Additional paid-in capital	16,368	14,109
Deficit	(11,486)	(7,183)
Total stockholders' equity	4,781	6,824
Total liabilities and stockholders' equity	\$ 35,644	\$ 37,101

See accompanying notes to consolidated financial statements.

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

	<b>Year Ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Revenues	\$ 88,943	\$ 75,725	\$ 41,985
Cost of revenues:			
Direct labor	56,681	47,353	24,406
Indirect labor and other contract support costs	25,173	19,256	14,054
Amortization of customer contracts	1,617	1,638	677
	83,471	68,247	39,137
Gross profit	5,472	7,478	2,848
Selling, general and administrative	11,370	11,682	6,133
Amortization of intangible assets	927	928	279
Operating loss	(6,825)	(5,132)	(3,564)
Income from joint venture, net		384	1,777
Interest and other income (expense):			
Interest income		12	44
Interest expense	(2,454)	(3,146)	(1,383)
Interest on preferred stock subject to mandatory redemption	(211)	(300)	(300)
Gain on sale of non-core assets		2,381	
Other income (expense)	2,549	274	(266)
	(116)	(779)	(1,905)
Loss before income taxes	(6,941)	(5,527)	(3,692)
Income tax benefit	(2,638)	(1,694)	(1,414)
Net loss	\$ (4,303)	\$ (3,833)	\$ (2,278)
Basic and diluted net (loss) per common share	\$ (1.02)	\$ (1.11)	\$ (0.74)
Basic and diluted weighted average number of common shares	4,203	3,448	3,097

See accompanying notes to consolidated financial statements.

**Table of Contents****Index to Financial Statements****Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Shareholders' Equity****(In thousands)**

	Common Stock		Treasury Stock		Series A Convertible Preferred Stock		Series B Convertible Preferred Stock		Additional	Retained	Total
	Shares	Cost	Shares	Cost	Shares	Cost	Shares	Cost	Capital	Deficit	
Balance at December 31, 2004	828	\$ 1			100	\$ 460	40	\$ 196	\$ 115	\$ (1,040)	\$ (268)
Recapitalization	372				(100)	(460)	(40)	(196)			(656)
IPO including warrants related to IPO, net of issue costs of \$633	2,070	2							10,885		10,887
Shares issued for services and interest	69								334		334
Options issued for services									59		59
Beneficial conversion of convertible notes									1,093		1,093
Warrants issued									1,263		1,263
Net loss										(2,278)	(2,278)
Balance at December 31, 2005	3,339	3							13,749	(3,318)	10,434
Shares issued for services	40								180		180
Shares issued for conversion of notes payable	73								326		326
Note receivable repaid through issuance of treasury stock			45	(105)							(105)
Options exercised	97								12		12
IPO expenses									(108)		(108)
Beneficial conversion of convertible notes									(425)		(425)
Stock compensation									375		375
Net loss										(3,833)	(3,833)
Balance at December 31, 2006 as previously reported	3,549	3	45	(105)					14,109	\$ (7,151)	\$ 6,856
FIN 48 adjustment										(32)	(32)
Balance at December 31, 2006 as restated	3,549	3	45	(105)					14,109	(7,183)	6,824
Shares issued for Paragon settlement	700	1							1,597		1,598
Beneficial conversion									426		426
Stock compensation									236		236
Net loss										(4,303)	(4,303)
Balance at December 31, 2007	4,249	\$ 4	45	\$ (105)		\$		\$	\$ 16,368	\$ (11,486)	\$ 4,781

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2007	2006	2005
<b>Cash flow from operating activities:</b>			
Net loss	\$ (4,303)	\$ (3,833)	\$ (2,278)
<b>Adjustments to reconcile net loss to net cash used by operating activities:</b>			
Gain on Paragon settlement	(1,888)		
Gain on Cornwall settlement	(250)		
Gain on sale of non-core assets		(2,381)	
Payment made for Paragon settlement	(1,250)		
Income from joint venture, net		(384)	(1,777)
Bad debt expense	488	59	329
Depreciation and amortization	2,920	2,909	1,065
Deferred income tax benefits	(1,974)	(3,095)	(1,193)
Common shares, options and warrants in exchange for services and interest	238	377	334
Non-cash interest expense	837	875	369
<b>Changes in operating assets and liabilities, net of effects of acquisition:</b>			
Unbilled revenues and trade accounts receivable	(1,168)	(2,345)	(2,212)
Prepaid expenses and other assets	(52)	418	21
Trade accounts payable	878	(95)	601
Accrued liabilities	319	(1,486)	(697)
Income taxes payable	(683)	1,426	(242)
<b>Net cash used by operating activities</b>	<b>(5,888)</b>	<b>(7,555)</b>	<b>(5,680)</b>
<b>Cash flow from investing activities:</b>			
Acquisition of subsidiary, net of cash acquired		(3)	(12,286)
Proceeds from sale of investment in joint venture		10,810	
Distributions from investment in joint venture		175	1,381
Proceeds from sale of assets		1,301	
Purchase of property and equipment	(254)	(203)	(100)
<b>Net cash provided (used) by investing activities</b>	<b>(254)</b>	<b>12,080</b>	<b>(11,005)</b>
<b>Cash flow from financing activities:</b>			
Proceeds from initial public offering			10,887
Repayment of notes issued for purchase of Paragon			(7,764)
Proceeds from issuance of notes and warrants			8,015
Proceeds from exercise of stock options		9	
Proceeds from factoring facility, net	4,119	315	2,107
Proceeds of (repayments on) term loans	2,500	(5,092)	5,150
Deferred financing costs	(78)	(43)	(1,560)
Deferred initial public offering costs		(111)	
<b>Net cash provided (used) by financing activities</b>	<b>6,541</b>	<b>(4,922)</b>	<b>16,835</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>399</b>	<b>(397)</b>	<b>150</b>

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Cash and cash equivalents at beginning of period	66	463	313
Cash and cash equivalents at end of period	\$ 465	\$ 66	\$ 463
Supplemental disclosures of cash flow information:			
Interest paid	\$ 1,850	\$ 1,873	\$ 1,491
Income taxes paid	15	149	423
Satisfaction of officer note through issuance of treasury stock		105	
	See accompanying notes to consolidated financial statements.		

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**Tri-S Security Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(dollars in thousands, except per share data)**

**1. Organization and Nature of Business**

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

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

**2. Basis of Presentation and Principles of Consolidation**

**Summary of Significant Accounting Policies**

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

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

In January 2006, Paragon Systems entered into a Joint Venture Agreement with Southeastern Protective Services, Inc. ( Southeastern Protective Services ) to form Southeastern Paragon. Paragon Systems owns 49% and Southeastern Protective Services owns 51% of SEP. SEP was formed to bid on certain contracts, and Paragon Systems will manage the contracts awarded to SEP. We are accounting for the joint venture in accordance with FIN 46 (R) Variable Interest Entities because we believe that SE Paragon is a VIE in which we are the primary beneficiary. In 2007, Tri-S recorded revenue from SE Paragon of \$5.7 million.

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

All significant intercompany transactions have been eliminated.

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#### **Liquidity**

The Company has historically incurred losses and has not yet generated sufficient levels of cash flows from operating activities to meet its scheduled debt service payments and other obligations. Additionally, the Company's 10% Convertible Notes with an outstanding principal balance of \$7,473,000 mature in September and October of 2008. The Company anticipates that the recently awarded contracts along with the initiatives instituted to maximize cash flows and raise additional equity will alleviate any short-term liquidity issues facing the Company. Management is also evaluating various alternatives to restructure the 10% Convertible Notes which mature later this year. Management believes these initiatives will contribute toward achieving profitability and alleviating the liquidity issues facing the Company. The ultimate timing and ability of the Company to achieve positive cash flow, raise equity and restructure the 10% Convertible Notes cannot be determined at this time. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

#### **Use of Estimates**

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

#### **Revenue Recognition**

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

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

Contracts with Federal government agencies may be subject to cessation of funding. Cessation of funding may result in amounts billed and recorded as revenue as being uncollectible. We work with the appropriate government agency to resolve funding issues. When funding issues become known, we make estimates and judgments about the extent of potential losses and adjust revenues accordingly. Amounts estimated could differ from amounts ultimately collected and these amounts could be material. During 2007, 2006 and 2005, none of our contracts have been subject to cessation of funding.

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

#### **Cost of Revenues**

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

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

#### **Impairment of Long-lived Assets, Goodwill and Intangible Assets**

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

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

#### **Investment in Joint Venture**

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

#### **Fair Value of Financial Instruments**

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

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Management does not believe it is practicable to determine the fair value of its series D Preferred Stock because of the uncertainties in related party aspects of this liability. The carrying amounts of the Company's debt, including the factoring facility and term loan approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at December 31, 2007 and 2006.

### **Retirement Plan**

Substantially all of Paragon's employees are eligible to participate in a 401(k) profit sharing plan. Under the terms of the plan, employees may elect to defer up to ten percent of their compensation subject to Internal Revenue Service limitations. Paragon may provide discretionary matching contributions on these deferrals each year based upon determinations by the board of directors. Paragon did not make any matching contributions for 2007, 2006 and 2005.

### **Cash Equivalents**

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

### **Accounts Receivable and Allowance for Doubtful Accounts**

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

### **Property and Equipment**

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

### **Income Taxes**

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

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

### **Stock-based Compensation**

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

### **Net loss per share**

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

**3. Stock-based Compensation**

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. Statement 123(R) supersedes APB Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees,

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and amends FASB Statement No. 95, Statement of Cash Flows. The approach to accounting for share-based payments in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and no longer allows pro forma disclosure as an alternative to financial statement recognition.

Effective January 1, 2006, the Company adopted Statement 123(R) using the modified prospective method and, therefore, reflects compensation expense in accordance with the SFAS 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates.

In accordance with SFAS 123(R), the Company recorded \$236,000 and \$377,000 of stock-based compensation expense for the years ended December 31, 2007 and 2006, respectively, related to employee stock options. If these options continued to be accounted for under APB 25 there would be no such expense recorded. After recording the expense through December 31, 2007, there remained approximately \$271,000 of unrecognized compensation cost related to unvested employee stock options to be recognized over the next 3 years.

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

Expected Dividend Yield

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

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

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

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

Year Ended December 31,	2007		2006		2005	
Expected Dividend Yield						
Expected Volatility in Stock Price	50.19	53.2%	48.91	51.86%		67.94%
Weighted Average Volatility		51.78%		51.79%		67.94%
Risk-Free Interest Rate	3.54	4.59%	4.67	5.03%	4.13	4.43 %
Expected Life of Stock Awards	5 years		5 years		5 years	
Weighted Average Fair Value at Grant Date	\$ 2.33		\$ 1.51		\$ 2.73	

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 for the year ended December 31, 2005 (in thousands, except per share data):

Net loss, as reported	\$ (2,278)
Add: Total stock-based employee compensation, net of tax	
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of tax	(87)

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Pro forma net loss \$ (2,365)

### Earnings per share:

Basic and diluted as reported	\$ (0.74)
Basic and diluted pro forma	\$ (0.76)

#### 4. Acquisition of The Cornwall Group

On October 18, 2005, the Company acquired all of the outstanding capital stock of The Cornwall Group, Inc. ( Cornwall ) for a total purchase price of \$13.5 million. Cornwall is comprised of 6 operating subsidiaries which provide security guard services in South Florida. After adjusting for certain working capital items, the net purchase price was \$12,753,000.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. The acquisition date used for accounting purposes was September 30, 2005 (in thousands).

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Current assets	\$ 4,950
Property, plant and equipment	1,347
Other assets	313
Customer contracts	5,495
Other Intangibles	1,070
Goodwill	8,335
Total assets acquired	21,510
Total liabilities assumed	8,757
Net assets acquired	\$ 12,753

Customer contracts represent the estimated fair value of the customer contracts in place as of the acquisition date and will be amortized over 4 years which represents the estimated life of the contracts.

Goodwill represents the purchase price of the acquired company less the fair value of the net assets acquired.

Other intangible assets include the value of a non-compete agreement, trademarks and trade names and software. Other intangibles are amortized for 1 - 5 years based on the estimated lives of the assets.

As a result of the acquisition of Cornwall, the Company recorded a net deferred tax liability of \$2,235,000. This deferred tax liability results from the difference between financial reporting and income tax bases of assets and liabilities purchased.

The following unaudited combined pro forma financial information presents the results of operations of the Company as if the acquisition had occurred at the beginning of the period presented. Adjustments to the combined financial information related to the acquisition that affect the results of operations include the interest expense associated with the debt issued in conjunction with the acquisition and amortization of the fair value of intangible assets. This pro forma information does not purport to be indicative of what would have occurred had the acquisition occurred as of January 1 or of results of operations that may occur in the future. The combined pro forma statement of operations for the year ended December 31, 2005 (in thousands) is as follows:

Revenues	\$ 70,870
Operating loss	(4,471)
Net (loss)	(4,635)
Basic and diluted net (loss) per common share	(1.50)

**5. Sales to Major Customers**

During 2007, 2006 and 2005, 55%, 46% and 76% of the Company's revenue was earned under contracts with various Federal government agencies through its Paragon Systems/SEP subsidiary. At December 31, 2007 and 2006, approximately 60% and 57% of accounts receivable were due from various Federal government agencies, respectively.

**6. Related Party Transactions****Note Receivable from CEO**

Pursuant to Mr. Farrell's employment agreement with the Company, Mr. Farrell, Chief Executive Officer and President of the Company, would have otherwise been entitled to receive during 2004 an aggregate bonus of \$435,000; however, in order to improve the financial position of the Company, he agreed to forfeit \$290,000 thereof and accept a cash bonus of \$145,000 and a loan for \$100,000. In connection with the loan, Mr. Farrell issued a promissory note to the Company dated December 31, 2004 in the principal amount of \$100,000, which bears interest at a rate of 2.48% per year and is payable on December 31, 2006. The note may be prepaid at any time without penalty and may be paid, at the election of Mr. Farrell, in cash or shares of the Company's common stock or any combination thereof. During December 2006, Mr. Farrell repaid the loan balance and accrued interest in 45,424 shares of the Company's common stock. These shares are reflected as treasury stock on the



accompanying balance sheet at a cost of \$105,021.

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**Table of Contents****Index to Financial Statements****Employment Agreements**

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

On November 19, 2007, the Company entered into an employment agreement with Nicolas V. Chater, pursuant to which Mr. Chater has agreed to serve as the Company s Chief Financial Officer until June 30, 2010 (the Employment Agreement ). Pursuant to the Employment Agreement, the Company has agreed to pay Mr. Chater for his service as the Company s Chief Financial Officer as follows: (i) a base salary at a rate of \$250,000 per year, (ii) an annual retention bonus equal to \$25,000 per year and (iii) an annual performance bonus equal to 3% of the Company s EBITDA, as adjusted (defined as earnings before interest, income taxes, depreciation, amortization, non-cash stock-based compensation and other income/expense), for such year; provided, that (a) the annual performance bonus may not exceed 100% of the base salary for such year and (b) Mr. Chater s 2008 performance bonus shall not be less than \$90,000. The Employment Agreement also provides that, if Mr. Chater s employment is terminated by the Company without cause or by him for good reason, then Mr. Chater shall be entitled to receive a single lump sum in an amount equal to his then-current salary and performance bonus and shall be entitled to participate in the Company s employee benefit, retirement and compensation plans during the twelve-month period following the date of such termination. Notwithstanding the foregoing, if Mr. Chater s employment is terminated by the Company without cause during the 24-month period following a change of control of the Company, then Mr. Chater will be entitled to receive a lump sum payment of his then-current performance bonus and twice his then-current base salary and shall be entitled to participate in the Company s employee benefit, retirement and compensation plans during the 24-month period following the date of such termination.

The Company has also agreed to grant to Mr. Chater, pursuant to the Company s Amended and Restated 2004 Stock Incentive Plan (the Incentive Plan ), an option to purchase 100,000 shares of the Company s common stock, with one-half of the underlying shares vesting on each of the first anniversary and the second anniversary of the date of grant. The option will have an exercise price equal to the fair market value of the Company s common stock on the date of grant. Subject to availability under the Incentive Plan, the Company has also agreed to grant Mr. Chater an option to purchase up to 50,000 shares of the Company s common stock on each anniversary of the execution of the Employment Agreement, with such options vesting equally over a two-year period (the Subsequent Options ). The Subsequent Options will have an exercise price equal to the fair market value of the Company s common stock on the date of grant.

**7. Property and Equipment**

Property and equipment are comprised of the following:

	Estimated Useful Life	December 31, 2007      2006 (in thousands)	
Vehicles	3 - 5 years	48	44
Computer equipment and software	3 - 5 years	397	393
Field equipment	3 - 5 years	632	355
Furniture and fixtures	5 years	147	147
Leasehold Improvements	5 years	32	32

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	1,256	971
Less accumulated depreciation and amortization	(780)	(374)
Property and equipment, net	\$ 476	\$ 597

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Depreciation expense for Tri-S was \$375,000, \$341,000 and \$76,000 for the years ended December 31, 2007, 2006 and 2005.

**8. Investment in Army Fleet Support, LLC**

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

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

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

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

The investment in the Joint Venture was effected by the following transactions for the years ended 2006 and 2005 (in thousands):

	2006	2005
Investment in Army Fleet Support beginning	\$ 8,698	\$ 8,302
Company's share of earnings in Army Fleet Support	659	2,601
Amortization of the investment in Army Fleet Support	(275)	(824)
Cash received from Army Fleet Support	(175)	(1,381)
Sale of investment in Army Fleet Support	(8,907)	
 Investment in Joint Venture ending	 \$	 \$ 8,698

Summarized unaudited statement of operations information for the unconsolidated Joint Venture for the year ended 2005 is as follows (in thousands):

	Year Ended Dec 31, 2005
Contract revenues	\$ 298,746
Operating income	25,958
Net earnings	26,005

**9. Goodwill and Intangible Assets**

Intangible assets are summarized as follows (in thousands):

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	2007	2006	Amortization Period
<b>Intangible assets:</b>			
Customer Contracts	\$ 6,875	\$ 6,875	1 -9 years
Non-compete agreements	696	696	1 -5 years
Loan Costs	2,014	1,953	1 -3 years
Other	95	95	
Gross carrying value of intangible assets subject to amortization	9,680	9,619	
<b>Less accumulated amortization:</b>			
Customer Contracts	(4,228)	(2,614)	
Non-compete agreements	(607)	(415)	

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	2007	2006	Amortization Period
Loan Costs	(1,499)	(806)	
Other	(74)	(45)	
Accumulated amortization	(6,408)	(3,880)	
Net carrying value of amortizable intangibles	3,272	5,739	
Non-amortizable intangibles:			
Trademarks	659	659	
Goodwill	16,078	16,078	
Total intangibles, net	\$ 20,009	\$ 22,476	

The changes in the carrying amount of goodwill during the years ended December 31, 2007 and 2006 are as follows (in thousands):

Balance, December 31, 2005	\$ 15,615
Net adjustments related to the Cornwall acquisition	463
Balance, December 31, 2006 and 2007	\$ 16,078

Amortization of intangible assets for the years ended December 31, 2007, 2006 and 2005 was \$2,545,000, \$2,566,000, and \$1,004,000 respectively. The Company does not have tax deductible goodwill.

Estimated future amortization expense for intangible assets on the Company's December 31, 2007 consolidated balance sheet for the fiscal years ending December 31, is as follows (in thousands):

2008	\$ 2,084
2009	1,117
2010	58
2011	13
	\$ 3,272

**10. Debt and Other Obligations**

The debt of the Company as of December 31, 2007 and 2006 consists of the following (in thousands):

	2007	2006
Short term borrowings under the Credit Agreement	\$ 11,625	\$ 7,506
2007 term loan	2,500	
Convertible Notes, face value of \$8,015 bearing interest at 26.1%, cash interest payable monthly at 10% annual rate, due on various dates in September and October 2008	7,473	7,273
Note payable, bearing interest at 5%, due April 2007		250
Other long-term debt	8	34
Series D Preferred Stock	1,500	

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Series C Preferred Stock		6,000
Total debt	23,106	21,063
Less: current debt	19,106	13,790
Long term debt	\$ 4,000	\$ 7,273

**Amended and Restated Credit Agreement**

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

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In connection with the Credit Agreement, we entered into a Factoring and Security Agreement (the "Factoring Agreement") with LSQ, pursuant to which LSQ will purchase from us from time to time certain accounts receivable at a discount of 0.7% and provide us with a professional accounts receivable management service for a funds usage fee of the prime rate plus 1.0% on the funds advanced on the outstanding accounts receivable purchased. The Factoring Agreement has a \$6,000,000 initial purchase limit and a four-year term which will automatically renew unless we provide notice of our intent to terminate. The Factoring Agreement amends and restates the Factoring Agreement dated as of April 1, 2005 between LSQ and Paragon Systems, pursuant to which LSQ purchased from Paragon Systems from time to time certain accounts receivable at a discount of 0.7% under a factoring facility with a funds usage fee equal to the prime rate plus 1.00%, a \$6,500,000 initial purchase limit and a one-year term subject to annual renewal.

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

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

During March 2007, we entered into an Amendment and Forbearance Agreement with our Lenders pursuant to which we amended the Credit Agreement and secured an additional \$2.5 million term loan (the "2007 Term Loan") with our Lenders to provide additional financing as needed to provide the capital we estimate is necessary to continue to operate the business during 2007. The 2007 Term Loan matures on March 28, 2009. The 2007 Term Loan bears a 0.25% per month fee on the unused portion of the loan.

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

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

Pursuant to the Loan and Security Agreement, at our request, LSQ shall make advances ("Advances") to us not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable through March 31, 2008 and at any time thereafter that the 2007 Term Loan has been repaid in full. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of (i) billed accounts receivable at a rate equal to the Prime Rate plus 1% and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5%. In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%. The Loan and Security Agreement expires on October 31, 2010.





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Under the Credit Agreement Supplement, anytime the 2007 Term Loan is outstanding and so long as unbilled accounts receivable are included in the borrowing base for purposes of making Advances, we must pay a monthly fee to our Lenders equal to 2.25% of the highest daily overadvance amount, which is the highest daily amount in any given month calculated as follows: the outstanding 2007 Term Loan, plus all outstanding Advances less the borrowing base.

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

The outstanding balance under the Amended and Restated Credit Agreement as of December 31, 2007 is approximately \$14.1 million. Additionally, from time to time during 2007, we have borrowed more than the maximum amount allowable under the availability formula in both the Amended and Restated Credit Agreement and the Original Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, The Company was not in compliance with the Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, the Company and its subsidiaries entered into an Amendment and Forbearance Agreement (the Agreement ) with the Lenders. Pursuant to the Agreement, the Lenders waived certain specified defaults under the Company's credit agreement with the Lenders and agreed to forebear from exercising all remedies available to the Lenders in connection with such existing defaults until the earlier of a potential equity or subordinated debt offering or January 1, 2009.

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

### **Convertible Notes**

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

The 10% Notes are convertible by the holders at an initial conversion price of \$4.80 per share subject to certain restrictions. The warrants issued have an exercise price of \$4.80 and expire three years from the date of issuance.

### **Redeemable Preferred Stock**

The Series C redeemable preferred stock was classified as preferred shares subject to mandatory redemption in the financial statements. On September 13, 2007, we entered into a Settlement Agreement and General Release (the Settlement Agreement ), among the Company, Paragon

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Systems, and Ronald G. Farrell, our Chief Executive Officer, on the one hand, and Charles Keathley, Robert Luther, John Wilson and Harold Bright, on the other hand (collectively, the Selling Shareholders ), with respect to all of the litigation pending among the Company, Paragon Systems, Mr. Farrell and the Selling Shareholders (collectively, the Litigation ). As a result of the Settlement Agreement, we cancelled the shares of the Company's Series C Redeemable Preferred Stock. Holders of the Series C Redeemable Preferred Stock had no voting rights, except that a consent of a majority of the holders of the Series C Redeemable Preferred Stock, voting separately as a class, is required to increase or decrease the number of authorized shares of Series C Redeemable Preferred Stock and except as

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otherwise required by applicable law. The Series C Redeemable Preferred Stock did not have any preemptive, conversion or sinking fund rights nor did it have any rights or preferences in the event of a liquidation, dissolution or winding-up of the Company.

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

**Table of Contents****Index to Financial Statements****Future Minimum Debt Payments**

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

2008	\$ 19,106
2009	2,500
2010	
2011	
2012	1,500
	\$ 23,106

**11. Income Taxes**

The benefit for income taxes consisted of the following for the years ended December 31, 2007, 2006 and 2005 (in thousands):

	2007	2006	2005
Current	\$ 664	\$ (1,406)	\$ 106
Deferred	2,456	3,100	1,308
(Increase)/Decrease in Valuation Allowance	(482)		
Income tax benefit	\$ 2,638	\$ 1,694	\$ 1,414

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and for net operating loss carryforwards. The significant components of deferred tax assets and liabilities as of December 31, 2007 and 2006 are as follows (in thousands):

	2007	2006
Deferred tax assets:		
Net operating loss carryforward	\$ 1,335	\$ 198
Allowance for doubtful accounts		27
Investment in Southeastern Paragon	177	77
Accrued expenses & other	108	2
Total deferred tax assets	\$ 1,620	\$ 304
Valuation Allowance	(482)	-0-
Net deferred tax assets	\$ 1,138	\$ 304
Deferred tax liabilities:		
Depreciation & amortization	\$ (1,134)	\$ (1,902)
IRC cash to accrual adjustment	(4)	(376)
Total deferred tax liabilities	(1,138)	(2,278)

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Net deferred income tax assets / (liabilities)	\$ -0-	\$ (1,974)
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As a result of the gain on the sale of the Company's investment in Army Fleet Support, tax payments of approximately \$1,457,350 were due in March 2007. These payments were not paid, but accrued. The Company's income tax provision as of December 31, 2007 reflects a benefit that will substantially offset its prior federal tax liability. However, the Company's state liability remains due and payable. As a result of the outstanding liabilities, the Company has also accrued penalties and interest totaling \$165,818.

At December 31, 2007, the Company had cumulative gross federal income tax net operating loss ( NOL ) carryforwards of approximately \$2,493,781 available to reduce future amounts of taxable income, the majority of which was created as a result of the consolidated 2007 operations. If not utilized to offset future taxable income the current NOL will expire in 2027. Additionally, the Company acquired through the Cornwall acquisition unused federal NOLs. Under Internal Revenue Code section 382, there is an annual limitation on the use of the NOLs acquired from Cornwall. If not utilized to offset future taxable income, the cumulative NOL amount will expire from 2020 through 2025. The Company also had approximately \$486,972 of tax effected state NOLs. If not utilized to offset future state taxable income, the state NOLs will expire between 2020 and 2027. For 2007, management has recorded a total valuation allowance of \$482,000 against its deferred tax assets including the NOL s.

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A reconciliation of the income tax provision computed at statutory tax rates for the years ended December 31, 2007, 2006 and 2005 is as follows:

	2007	2006	2005
Income tax benefit at statutory rate	34.0%	34.0%	34.0%
State income taxes, net of federal benefit	5.6	3.6	4.3
Preferred stock dividends	(1.0)	(1.9)	
Stock option compensation	(1.2)	(2.3)	
Resolution of income tax uncertainties from prior year	(1.3)	(2.3)	
Stock acquisition basis adjustments	11.4		
Valuation Allowance	(7.0)		
Non-deductible expenses and other		(0.4)	
<b>Income tax benefit</b>	<b>40.5%</b>	<b>30.7%</b>	<b>38.3%</b>

We adopted the provisions of FIN 48 on January 1, 2007. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. The adoption of FIN 48 resulted in the recognition of \$32,104 of penalties which was recorded as an adjustment to the January 1, 2007 retained earnings. No adjustments were made in the fourth quarter 2007 to the balance of unrecognized tax benefits and no material change is expected in the next twelve months. In addition, the following information required by FIN 48 is provided:

As noted above, as of January 1, 2007, we have accrued penalties in the amount of \$32,104 related to uncertain tax positions. As of December 31, 2007, the total amount of interest and penalties accrued was \$197,922. Accrued interest on tax deficiencies and tax penalties are recorded as a component of income tax expense.

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

The Company and its subsidiaries file federal income tax returns, as well as multiple state and local tax returns. The tax years of 2004 to 2006 for all jurisdictions remain open to examination.

**12. Lease Obligations****Operating Leases**

The Company leases real property and equipment under operating leases. Lease expense was \$1,186,000, \$1,033,000 and \$445,000 for 2007, 2006 and 2005, respectively. Included in lease expense is \$1,000 per month paid to two officers for rental of a building during 2005 through February 28, 2005.

**Future Minimum Operating Lease Payments**

Future minimum rental payments required under the operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2007 are as follows (in thousands):

2008	\$ 871
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2009	625
2010	320
2011	212
2012	30
Total	\$ 2,058

**13. Preferred and Common Stock**

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

On September 13, 2007, we entered into a Settlement Agreement and General Release (the Settlement Agreement ), among the Company, Paragon Systems, and Ronald G. Farrell, our Chief Executive Officer, on the one hand, and Charles



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Keathley, Robert Luther, John Wilson and Harold Bright, on the other hand (collectively, the Selling Shareholders ), with respect to all of the litigation pending among the Company, Paragon Systems, Mr. Farrell and the Selling Shareholders (collectively, the Litigation ). Pursuant to the Settlement Agreement:

- (i) the Company paid the Selling Shareholders an aggregate of \$1,250,000;
- (ii) the Selling Shareholders and the Company cancelled the shares of the Company s Series C Redeemable Preferred Stock held by the Selling Shareholders, which shares had an aggregate redemption value of \$6,000,000;
- (iii) the Selling Shareholders terminated and released their security interest in the outstanding shares of capital stock of Paragon;
- (iv) the Company issued to the Selling Shareholders an aggregate of 700,000 shares of common stock and an aggregate of 100 shares of the Company s newly-designated Series D Redeemable Preferred Stock (the Preferred Shares ), which Preferred Shares (a) have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012 or the date on which the Company sells 70% or more of its assets in one or more transactions (unless the proceeds from such sale are reinvested in the Company s business, used to restructure debt or used for acquisitions or working capital purposes), and (b) accrue dividends of \$750 per share per annum and are payable quarterly;
- (v) the Company agreed not to amend Mr. Farrell s employment agreement with the Company to increase or enhance the compensation or benefits payable to him thereunder until September 13, 2008;
- (vi) the Company agreed to issue to the Selling Shareholders an aggregate of 10% of any equity securities of the Company which are issued to Mr. Farrell during the period commencing on May 18, 2007 and ending on May 18, 2008;
- (vii) the Selling Shareholders granted to Mr. Farrell a proxy (the Voting Agreement ) to vote, in his sole and absolute discretion, an aggregate of 700,000 shares of common stock held by them until such time as such shares are sold by them to an unaffiliated party in accordance with the terms of the Securities Act of 1933, as amended (the Securities Act );
- (viii) the Company agreed to indemnify the Selling Shareholders for costs and expenses incurred by them relating to the litigation pending against the Company in the United States District Court for the Northern District of Georgia regarding the Company s initial public offering; and
- (ix) the Company, Paragon Systems and the Selling Shareholders released each other from all claims and obligations among them existing as of September 13, 2007 (except for obligations arising pursuant to the terms of the Settlement Agreement) and have agreed to cause the Litigation to be dismissed with prejudice.

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

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

During 2005, we issued 68,700 shares of our common stock for services and interest at an average price of \$4.87 per share. The Company recorded expense of \$334,000 related to the shares issued for services and interest. The value of the shares issued and related expense were computed based on the traded share price at the date of grant or issuance.

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

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

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**Table of Contents****Index to Financial Statements****14. Common Stock Options and Warrants**

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

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

In conjunction with the financing for the Cornwall acquisition, we issued 1,260,365 warrants to purchase common stock exercisable at \$4.80. 834,896 warrants were issued to the purchasers of the 10% Convertible Notes, 250,469 warrants were issued to the underwriters of the 10% Convertible Notes Offering and 175,000 were issued to the lender under the Credit Agreement.

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

Warrants for 16,181 shares of common stock were issued on July 27, 2004 with an exercise price of \$3.09 per share. These warrants expired on February 9, 2006.

The 2004 Stock Incentive Plan ( Stock Incentive Plan ) was approved and adopted by the board of directors and shareholders on October 13, 2004. The Stock Incentive Plan is administered by the compensation committee of the board of directors in accordance with and subject to the provisions of the Stock Incentive Plan. The committee has the authority to determine all provisions of incentive awards as the committee may deem necessary or desirable and as consistent with the terms of the Stock Incentive Plan. During 2006, the Stock Incentive Plan was amended to revise the maximum number of shares of common stock that are available for issuance under the Stock Incentive Plan from 500,000 to 1,500,000, less the aggregate number of shares already issued pursuant to Stock Incentive Plan, all of which are available for future grant. The Stock Incentive Plan will terminate at midnight no later than October 13, 2014, unless terminated earlier by action of the board of directors.

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

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

The following table summarizes employee stock option activity for the years ended December 31, 2007, 2006 and 2005:

	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Outstanding at December 31, 2004	97,087	\$ 0.12	
Granted	243,500	4.55	2.72
Exercised			
Canceled or Expired			
Outstanding at December 31, 2005	340,587	3.29	

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Granted	216,500	2.99	1.50
Exercised	(97,087)	0.12	

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	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Canceled or Expired	(8,300)	3.00	
Outstanding at December 31, 2006	451,700	3.83	
Granted	460,000	2.33	1.15
Exercised			
Canceled or Expired	(372,850)	3.42	
Outstanding at December 31, 2007	538,850	2.84	

A summary of the status of our nonvested stock options as of December 31, 2007 and changes during the year ended December 31, 2007, is presented below.

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2007	306,333	\$ 2.15
Granted	366,667	2.27
Vested	(62,117)	3.68
Forfeited	(269,983)	3.38
Nonvested at December 31, 2007	340,900	2.56

As at December 31, 2007, there was approximately \$271,000 of unrecognized compensation cost related to unvested share-based compensation awards granted. We expect to recognize this cost over the next 3 years.

Options exercisable at December 31, 2007 and 2006 were 197,950 and 148,667, respectively.

The following table summarizes additional information about employee stock options outstanding at December 31, 2007:

Range of Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2007	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2007	Weighted Average Exercise Price
\$2.00-4.75	538,850	9 years	\$ 2.84	197,950	\$ 3.30

The following table summarizes the warrants outstanding for the years ended December 31, 2007 and 2006.

	2007	2006	Weighted Average Exercise Price
Warrants issued and outstanding related to IPO	2,430,000	2,430,000	\$ 6.18
Warrants issued and outstanding related to issuance of 10% Notes Payable	1,085,365	1,085,365	\$ 4.80
Warrants issued and outstanding related to Credit Agreement	175,000	175,000	\$ 4.80

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Total warrants outstanding	3,690,365	3,690,365
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Restricted stock awards are awards of common stock granted to a recipient which are subject to restrictions on transferability and the risk of forfeiture. The Compensation Committee may impose such restrictions or conditions to the vesting of restricted stock awards, including that the participant remain in the continuous employ or service of the Company for a specified period of time or that the participant or the Company satisfy specified performance goals or criteria.

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

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**Table of Contents****Index to Financial Statements****15. Sale of Certain Home Monitoring Customer Contracts of International Monitoring, Inc.**

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

The details of the transaction are as follows:

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

**16. Cornwall Settlement**

At the closing of our acquisition of Cornwall (see Note 4, we paid a total purchase price of \$13,500,000 payable as follows: (i) payment of \$12,825,000 in cash; (ii) delivery of a promissory note in principal amount of \$250,000 payable to the former Cornwall shareholders (the Cornwall Promissory Note ); and (iii) deposit of \$425,000 with an escrow agent to secure the indemnification obligations of the former Cornwall shareholders under the Stock Purchase Agreement between us and the former Cornwall shareholders dated as of August 11, 2005 (the Cornwall Purchase Agreement). After adjusting for certain working capital items, the net purchase price was \$12,753,000. On January 26, 2007, we entered into a Settlement Agreement and General Release (the Cornwall Settlement Agreement ) with David Shopay, on behalf of himself and the other former shareholders of Cornwall, in his capacity as the representative of such shareholders. Pursuant to the Cornwall Settlement Agreement (i) the parties waived and released each other from all claims and liabilities, with the exception of certain claims and liabilities specified in the Cornwall Settlement Agreement, arising from the Cornwall Purchase Agreement; (ii) the shareholder representative forgave and discharged all amounts owed by us to the former shareholders of Cornwall under the Cornwall Promissory Note; and (iii) the shareholder representative and the Company instructed the escrow agent administering the escrow fund to release \$200,000 from such fund to us and the remaining balance of such fund to the former shareholders of Cornwall. We recognized a gain of \$450,000 as other income on the accompanying statements of operations for the year ended December 31, 2007.

**17. Contingencies**

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

**18. Litigation****Legal Proceedings**

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

**Litigation with the Former Shareholders of Paragon Systems**

On September 13, 2007, we entered into a Settlement Agreement and General Release (the Settlement Agreement ), among the Company, Paragon Systems, and Ronald G. Farrell, our Chief Executive Officer, on the one hand, and Charles Keathley, Robert Luther, John Wilson and Harold Bright, on the other hand (collectively, the Selling Shareholders ), with respect to all of the litigation pending among the Company, Paragon Systems, Mr. Farrell and the Selling Shareholders (collectively, the Litigation ). Pursuant to the Settlement Agreement:

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- (i) the Company paid the Selling Shareholders an aggregate of \$1,250,000;
- (ii) the Selling Shareholders and the Company cancelled the shares of the Company's Series C Redeemable Preferred Stock held by the Selling Shareholders, which shares had an aggregate redemption value of \$6,000,000;
- (iii) the Selling Shareholders terminated and released their security interest in the outstanding shares of capital stock of Paragon Systems;

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

(v) the Company agreed not to amend Mr. Farrell's employment agreement with the Company to increase or enhance the compensation or benefits payable to him thereunder until September 13, 2008;

(vi) the Company agreed to issue to the Selling Shareholders an aggregate of 10% of any equity securities of the Company which are issued to Mr. Farrell during the period commencing on May 18, 2007 and ending on May 18, 2008;

(vii) the Selling Shareholders, pursuant to a Voting Agreement, granted to Mr. Farrell a proxy to vote, in his sole and absolute discretion, an aggregate of 700,000 shares of common stock held by the Selling Shareholders until such time as such shares are sold by them to an unaffiliated party in accordance with the terms of the Securities Act;

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

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

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

**Litigation Regarding Our Initial Public Offering and Related Insurance Coverage**

On November 1, 2006, a purported class action complaint was filed in the State Court of Fulton County, State of Georgia, against Tri-S Security, its Chief Executive Officer, its former Chief Financial Officer and the lead underwriters in Tri-S Security's initial public offering, alleging, among other things, violations of Sections 11, 12(a)(2) and 15 of the Securities Act in connection with Tri-S Security's initial public offering (*Unschuld v. Tri-S Security Corp., et al.*, the *Unschuld Litigation*). More specifically, the complaint alleges that the registration statement relating to the initial public offering was materially inaccurate and misleading because it failed to disclose certain problems with the operations and financial condition of Paragon Systems of which the complaint alleges we were aware. The complaint seeks class certification, unspecified compensatory damages or rescission, as appropriate, and costs and disbursements relating to the lawsuit, including reasonable attorneys' fees. On December 1, 2006, Tri-S Security removed the lawsuit to the United States District Court for the Northern District of Georgia. Plaintiff moved to remand the case back to the state court, which motion was granted on September 14, 2007, and the case is now pending in the State Court of Fulton County, State of Georgia. The deadline for Tri-S Security to respond to the Complaint is March 21, 2008, but the parties have agreed to extend that deadline to April 21, 2008. The Company intends to vigorously defend the action and believes it has meritorious defenses to the allegations.

On December 10, 2007, Tri-S Security filed an action in the Superior Court of Fulton County, State of Georgia, against Axis Reinsurance Company and Axis Insurance Company ( *Axis* ) for declaratory and injunctive relief. Axis issued a Directors, Officers, and Corporate Liability Insurance Policy to Tri-S Security for the period from March 13, 2006 to March 13, 2007 (the *Axis Policy* ). Tri-S Security provided notice of the *Unschuld Litigation* to Axis on November 8, 2006. On November 9, 2007, attorneys for Axis informed Tri-S Security that Axis disclaimed coverage for the *Unschuld Litigation*. Tri-S Security seeks (i) a declaratory judgment that coverage for the *Unschuld Litigation* is not barred by an exclusion in the *Axis Policy* related to the litigation with the Selling Shareholders of Paragon Systems and that Axis is required to advance defense costs incurred in connection with the *Unschuld Litigation* and (ii) an order requiring Axis to advance such defense costs.

On March 13, 2008, Tri-S Security filed an action in the Superior Court of Fulton County, State of Georgia, against Capitol Specialty Insurance Corporation ( *Capitol* ), McGriff, Seibels & Williams of Georgia, Inc. and McGriff, Seibels & Williams, Inc. (collectively, *McGriff* ), seeking declaratory relief and damages. McGriff acted as Tri-S Security's broker in obtaining the *Axis Policy*. Capitol issued a Directors and Officers

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Liability Insurance Policy to Tri-S for the period from February 9, 2005 to March 13, 2006 (the Capitol Policy ). Tri-S Security provided notice under the Capitol Policy of the Unschuld Litigation on December 13, 2007. Coverage under that policy was denied on January 25, 2008. In the event that the Unschuld Litigation is not covered under the Axis Policy, Tri-S Security is seeking (i) a declaration that the Capitol Policy requires Capitol to advance defense costs in connection with the Unschuld Litigation; (ii) an order requiring Capitol to advance such defense costs; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for any such loss. In the event that Tri-S Security is not fully covered under either the Axis Policy or the Capitol Policy in connection with the Unschuld Litigation, Tri-S Security is seeking (a) damages, in an amount to be determined at trial, against McGriff for negligence, breach of contract, negligence per se, negligent procurement, negligent misrepresentation, professional negligence, and breach of fiduciary duty; (b) a declaration that McGriff is required to cover any loss as defined in the Axis Policy that Tri-S Security incurs in connection with the Unschuld Litigation up to the limit of liability of the Axis Policy; and (c) an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation.

### **Dispute with Miami-Dade General Services Administration**

A search warrant was issued on January 17, 2008 by the Circuit Court of the eleventh judicial circuit in and for Miami-Dade County, Florida to search the premises of Forestville Security, a subsidiary of Tri-S Security based in Miami for any and all records or documents pertaining to the contract between Forestville Security ( Forestville ) and Miami-Dade General Services Administration ( GSA ) for the period of April 1, 2005 to August 1, 2007.

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The search warrant states that GSA is alleging that it has uncovered instances of fraudulent billing committed by Forestville in connection with the GSA contract. Forestville is fully cooperating with the authorities regarding the investigation.

The Company believes that it has meritorious defenses to the allegations made and is vigorously defending these proceedings. Accordingly, the Company has not established a litigation reserve.

**19. Segment Information**

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

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

	<b>Total</b>	<b>Cornwall</b>	<b>Paragon Systems/SEP</b>	<b>Other</b>
<b>2007</b>				
Revenues	\$ 88,943	\$ 39,951	\$ 48,992	\$
Amortization and depreciation	2,920	1,711	506	703
Operating loss	(6,825)	(1,267)	(1,376)	(4,182)
Current assets	15,159	6,185	8,963	11
Goodwill	16,078	8,331	7,747	
Other Intangibles	3,931	3,061	378	492
Total assets	35,644	17,773	17,315	556
<b>2006</b>				
Revenues	\$ 75,725	\$ 40,875	\$ 34,850	\$
Amortization and depreciation	2,907	1,808	424	675
Operating loss	(5,132)	(252)	(1,004)	(3,876)
Current assets	14,028	6,260	7,742	26
Goodwill	16,078	8,331	7,747	
Other Intangibles	6,398	4,530	725	1,143
Total assets	37,101	19,494	16,367	1,240
<b>2005</b>				
Revenues	\$ 41,985	\$ 10,011	\$ 31,974	\$
Amortization and depreciation	1,018	430	432	156
Operating loss	(3,564)	(647)	(453)	(2,464)
Current assets	12,453	6,082	6,187	184
Investment in joint venture	8,698		8,698	
Goodwill	15,615	7,868	7,747	
Other Intangibles	9,010	6,174	1,080	1,756
Total assets	47,345	21,454	23,787	2,104

**Table of Contents****Index to Financial Statements****19. Selected Quarterly Financial Data (Unaudited)**

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

	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
	(in thousands, except per share data)			
<b>2007</b>				
Revenue	\$ 20,205	\$ 21,426	\$ 23,805	\$ 23,507
Gross profit	1,853	1,276	1,517	826
Net income (loss) attributable to common shareholders	(676)	(1,593)	153	(2,187)
Basic and diluted net income (loss) per share attributable to common shareholders	(0.19)	(0.45)	0.04	(0.59)
<b>2006</b>				
Revenue	\$ 17,373	\$ 17,704	\$ 19,984	\$ 20,664
Gross profit	1,999	1,806	1,809	1,864
Net loss attributable to common shareholders	(1,649)	(59)	(814)	(1,311)
Basic and diluted net loss per share attributable to common shareholders	(0.49)	(0.02)	(0.23)	(0.37)
<b>2005</b>				
Revenue	7,979	7,745	8,063	18,198
Gross profit	348	753	371	1,376
Net income (loss) attributable to common shareholders	(46)	124	(430)	(1,926)
Basic and diluted net income (loss) per share attributable to common shareholders	(0.02)	0.04	(0.13)	(0.58)

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<b>Column A Description</b>	<b>Column B Balance at beginning of period</b>	<b>Column C Charged to costs and expenses</b>	<b>Additions Charged to other accounts describe</b>	<b>Column D Deductions describe</b>	<b>Column E Balance at end of period</b>
Bad Debt Reserve (in thousands):					
Year ended December 31, 2007	\$ 797	\$ 488	\$	\$ 584(2)	\$ 701
Year ended December 31, 2006	\$ 1,181	\$ 59	\$	\$ 443(2)	\$ 797
Year ended December 31, 2005	537	329	695(1)	380(2)	1,181

- (1) Established Bad Debt Reserve for accounts receivable acquired as part of Cornwall acquisition estimated to be uncollectible.  
(2) Write-offs.

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**SIGNATURES**

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

**TRI-S SECURITY CORPORATION**

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

Date: March 31, 2008

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

<b>Name</b>	<b>Title</b>	<b>Date</b>
/s/ RONALD G. FARRELL	Chairman of the Board and Chief Executive Officer	March 31, 2008
Ronald G. Farrell	(Principal Executive Officer)	
/s/ Nicolas V. Chater	Chief Financial Officer (Principal Financial Officer	March 31, 2008
Nicolas V. Chater	and Principal Accounting Officer)	
/s/ JAMES M. LOGSDON	Director	March 31, 2008
James M. Logsdon		
/s/ L.K. TOOLE	Director	March 31, 2008
L.K. Toole		
/s/ JAMES A. VERBRUGGE	Director	March 31, 2008
James A. Verbrugge		

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

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4.1	Form of Representative's Option for the Purchase of Warrants.	Incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.2	Form of Representative's Option for the Purchase of Common Stock.	Incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.3	Specimen Common Stock Certificate.	Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.4	Form of Warrant Agreement.	Incorporated by reference to Exhibit 4.4 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.5	Form of Warrant Issuable to Underwriters Upon Exercise of Option.	Incorporated by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.6	Specimen Warrant Certificate.	Incorporated by reference to Exhibit 4.6 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.7	Specimen Unit Certificate.	Incorporated by reference to Exhibit 4.7 to the Company's Registration Statement on Form S-1 (No. 333-119737).
4.8	Form of 10% Callable Convertible Promissory Note issued by the Company in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.9	Form of Warrant to purchase shares of the Company's common stock issued by the Company in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.10	Form of Registration Rights Agreement entered into by the Company and the investors signatory thereto in connection with the private placement of securities conducted on September 2, 2005.	Incorporated by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.11	Form of 10% Callable Convertible Promissory Note issued by the Company in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.



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4.12	Form of Warrant to purchase shares of the Company's common stock issued by the Company in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.13	Form of Registration Rights Agreement entered into by the Company and the investors signatory thereto in connection with the private placement of securities conducted on September 30, 2005, October 12, 2005 and October 14, 2005.	Incorporated by reference to Exhibit 4.6 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
4.14	Form of Warrant to purchase 150,000 shares of the Company's common stock issued to BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 2, 2006.
4.15	Form of Warrant to purchase 25,000 shares of the Company's common stock issued to LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on May 2, 2006.
10.1	Agreement Regarding Notes and Preferred Shares dated as of September 29, 2004, among the Company, Paragon Systems, Inc., Harold Bright, Charles Keathley, Robert Luther and John Wilson.	Incorporated by reference to Exhibit 10.6 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.2	Letter Agreement dated October 6, 2004, between the Company, Paragon Systems, Inc., Charles Keathley and Robert Luther.	Incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.3	Consent Agreement to Extend Promissory Notes dated as of September 7, 2004 among the Company, Paragon Systems, Inc., Harold Bright and John Wilson.	Incorporated by reference to Exhibit 10.8 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.4	Promissory Note dated February 24, 2004, made by the Company in favor of Harold Bright in the principal amount of \$526,900.	Incorporated by reference to Exhibit 10.9 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.5	Amended and Restated Promissory Note dated September 29, 2004, made by the Company in favor of Charles Keathley in principal amount of \$2,983,750.	Incorporated by reference to Exhibit 10.10 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.6	Amended and Restated Promissory Note dated September 29, 2004, made by the Company in favor of Robert Luther in principal amount of \$1,462,450.	Incorporated by reference to Exhibit 10.11 to the Company's Registration Statement on Form S-1 (No. 333-119737).

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10.7	Promissory Note dated February 24, 2004, made by the Company in favor of John Wilson in the principal amount of \$526,900	Incorporated by reference to Exhibit 10.12 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.8	Amended and Restated Promissory Note dated September 29, 2004, made by Paragon Systems, Inc. in favor of Charles Keathley, both individually and as agent for Robert Luther, Harold Bright and John Wilson, in principal amount of \$706,507.	Incorporated by reference to Exhibit 10.13 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.9	Pledge and Assignment of Stock and Security Agreement dated September 29, 2004, between the Company and Charles Keathley.	Incorporated by reference to Exhibit 10.14 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.10	Pledge and Assignment of Stock and Security Agreement dated September 29, 2004, between the Company and Robert Luther.	Incorporated by reference to Exhibit 10.15 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.11	Promissory Note dated February 24, 2004, made by the Company in favor of Harold Bright in principal amount of \$143,700.	Incorporated by reference to Exhibit 10.16 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.12	Promissory Note dated February 24, 2004, made by the Company in favor of Charles Keathley in principal amount of \$813,750.	Incorporated by reference to Exhibit 10.17 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.13	Promissory Note dated February 24, 2004, made by the Company in favor of Robert Luther Bright in principal amount of \$398,850.	Incorporated by reference to Exhibit 10.18 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.14	Promissory Note dated February 24, 2004, made by the Company in favor of John Wilson in principal amount of \$143,700.	Incorporated by reference to Exhibit 10.19 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.15	Security Agreement dated February 24, 2004, between the Company and Harold Bright.	Incorporated by reference to Exhibit 10.20 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.16	Security Agreement dated February 24, 2004, between the Company and Charles Keathley.	Incorporated by reference to Exhibit 10.21 to the Company's Registration Statement on Form S-1 (No. 333-119737).

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10.17	Security Agreement dated February 24, 2004, between the Company and Robert Luther.	Incorporated by reference to Exhibit 10.22 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.18	Security Agreement dated February 24, 2004, between the Company and John Wilson.	Incorporated by reference to Exhibit 10.23 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.19	Employment Agreement dated January 1, 2002, between the Company and Ronald G. Farrell. Represents an executive compensation plan or arrangement.	Incorporated by reference to Exhibit 10.24 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.20	Employment Agreement dated February 24, 2004, between Paragon Systems, Inc. and Harold Bright.	Incorporated by reference to Exhibit 10.26 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.21	Employment Agreement dated February 24, 2004, between Paragon Systems, Inc. and Charles Keathley.	Incorporated by reference to Exhibit 10.28 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.22	Employment Agreement dated February 24, 2004, between Paragon Systems, Inc. and Robert N. Luther.	Incorporated by reference to Exhibit 10.29 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.23	Employment Agreement dated February 24, 2004, between Paragon Systems, Inc. and John T. Wilson.	Incorporated by reference to Exhibit 10.30 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.24	Form of Exchange and Recapitalization Agreement among the Company and the holders of the Company's outstanding common stock, Series A Convertible Preferred Stock and Series B Convertible Preferred Stock.	Incorporated by reference to Exhibit 10.31 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.25	Agreement dated May 5, 2003, among Paragon Systems, Inc. and International Union of Security, Police and Fire Professionals of America.	Incorporated by reference to Exhibit 10.37 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.26	Agreement dated December 16, 2003 among Paragon Systems Inc. and International Union, Security, Police, and Fire Professionals of America.	Incorporated by reference to Exhibit 10.38 to the Company's Registration Statement on Form S-1 (No. 333-119737).

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10.27	Agreement dated March 1, 2002, between Paragon Systems, Inc. and International Technical and Professional Employees Union, AFL-CIO.	Incorporated by reference to Exhibit 10.39 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.28	Agreement dated December 1, 2003 between Paragon Systems, Inc. and United Union of Security Guards.	Incorporated by reference to Exhibit 10.40 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.29	Joint Venture Limited Liability Company Agreement for Army Fleet Support, LLC.	Incorporated by reference to Exhibit 10.41 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.30	2004 Stock Incentive Plan, as amended and restated as of November 7, 2006.	Incorporated by reference to Appendix A to the Company's Notice of Annual Meeting of Shareholders and Proxy Statement dated October 6, 2006.
10.31	Form of Indemnification Agreement.	Incorporated by reference to Exhibit 10.43 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.32	Paragon Systems, Inc. 401(k) Profit Sharing Plan, as amended.	Incorporated by reference to Exhibit 10.44 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.33	Letter Agreement dated November 30, 2004 among the Company, Charles Keathley and Robert Luther.	Incorporated by reference to Exhibit 10.62 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.34	Letter Agreement dated December 14, 2004 among the Company, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 10.63 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.35	Amendment No. 1 to Employment Agreement between the Company and Ronald G. Farrell. Represents an executive compensation plan of agreement.	Incorporated by reference to Exhibit 10.64 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.36	Form of Consulting Agreement among the Company, Capital Growth Financial, LLC and Bathgate Capital Partners LLC.	Incorporated by reference to Exhibit 10.65 to the Company's Registration Statement on Form S-1 (No. 333-119737).

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10.37	Promissory Note made by Ronald G. Farrell in favor of the Company dated December 31, 2004.	Incorporated by reference to Exhibit 10.66 to the Company's Registration Statement on Form S-1 (No. 333-119737).
10.38	Factoring Agreement dated April 2005 between Paragon Systems, Inc. and LSQ Funding Group, L.L.C.	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.
10.39	Summary of Board Compensation	Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.
10.40	Factoring Agreement dated April 2005 between Paragon Systems, Inc. and LSQ Funding Group, L.L.C.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report Form 8-K filed on April 26, 2005.
10.41	Office Lease Agreement between the Company and V.V. Georgia, L.P. dated June 29, 2005.	Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
10.42	Letter Agreement dated August 10, 2005 between the Company and Ronald G. Farrell. Represents an executive compensation arrangement or plan.	Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
10.43	Employment Agreement dated January 1, 2002, between the Company and Ronald G. Farrell. Represents an executive compensation arrangement or plan.	Incorporated by reference to Exhibit 10.24 to the Company's Registration Statement on Form S-1, as amended (No. 333-119737).
10.44	Employment Agreement between Paragon Systems, Inc. and Leslie Kaciban dated July 29, 2005.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on August 4, 2005.
10.45	Employment Agreement between Paragon Systems, Inc. and Mark Machi dated July 29, 2005.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on August 4, 2005.
10.46	Form of Qualified Stock Option Agreement.	Incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (No. 333-129097).

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10.47	Form of Non-Qualified Stock Option Agreement.	Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (No. 333-129097).
10.48	Letter Agreement between the Company and E. Wayne Stallings dated August 12, 2005.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on August 18, 2005.
10.49	Earnest Money Escrow Agreement dated as of August 30, 2005, among the Company, The Cornwall Group, Inc., the Shareholder Representative and Berman Renert Vogl & Mandler, P.A.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on September 2, 2005.
10.50	Promissory Note dated October 18, 2005 in principal amount of \$250,000 made by the Company in favor of the Shareholder Representative.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.51	Credit Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.3 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.52	Factoring and Security Agreement dated as of October 18, 2005 among the Company, its subsidiaries and LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.4 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.53	Security Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.5 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.54	Pledge Agreement dated as of October 18, 2005 among the Company, LSQ Funding Group, L.C. and BRE LLC	Incorporated by reference to Exhibit 99.6 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.55	Guaranty Agreement dated as of October 18, 2005 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.7 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.56	Employment Agreement between The Cornwall Group, Inc. and David H. Shopay dated October 18, 2005.	Incorporated by reference to Exhibit 99.8 to the Company's Current Report on Form 8-K filed on October 24, 2005.

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10.57	Escrow Agreement dated as of October 18, 2005 among the Company, SunTrust Bank and the Shareholder Representative.	Incorporated by reference to Exhibit 99.9 to the Company's Current Report on Form 8-K filed on October 24, 2005.
10.58	Amendment to Credit Agreement, dated as of December 30, 2005, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 6, 2006.
10.59	Amendment to Pledge Agreement, dated as of October 19, 2005, but executed on December 30, 2005, among the Company, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on January 6, 2006.
10.60	Agreement between International Monitoring, Inc. and Devcon Security Services Corporation dated March 2, 2006.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on March 8, 2006.
10.61	Amendment and Forbearance Agreement dated as of March 29, 2006 by and among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on April 4, 2006.
10.62	Agreement to sell certain real property located in Fort Lauderdale, Florida.	Incorporated by reference to Exhibit 10.92 on the Company's Annual Report on Form 10-K for the year ended December 31, 2005.
10.63	Letter Agreement dated April 10, 2006 between International Monitoring, Inc. and Devcon Security Services Corporation.	Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.
10.64	Joint Venture Agreement dated January 17, 2006 between Paragon Systems, Inc. and Southeastern Protective Services, Inc.	Incorporated by reference to Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.
10.65	Purchase Agreement dated as of May 19, 2006 among the Company, Paragon Systems, Inc. and L-3 Communications Integrated Systems, LP.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 23, 2006.
10.66	Summary of Board Compensation.	Incorporated by reference to Exhibit 10.6 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

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10.67	Guaranty of Joint Venture Executed by Paragon Systems, Inc. on June 27, 2006.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on June 30, 2006.
10.68	Waiver, Consent and Amendment among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC dated as of June 27, 2007.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on June 30, 2006.
10.69	Amendment to Employment Agreement between the Company and Ronald G. Farrell dated January 10, 2007.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 11, 2007.
10.70	Settlement Agreement and General Release dated January 26, 2007, between the Company and David Shopay, on behalf of himself and the other former shareholders of The Cornwall Group, Inc.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on February 1, 2007.
10.71	Copy of the selected portions of the Investor Fact Sheet released on or about January 24, 2007.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on February 7, 2007.
10.72	Amendment and Forbearance dated as of March 23, 2007 among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 10.79 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.73	Acknowledgment of Forbearance and Reaffirmation of Guaranty dated as of March 23, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BLE LLC.	Incorporated by reference to Exhibit 10.80 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.74	Pledge Agreement dated as of March 23, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BLE LLC.	Incorporated by reference to Exhibit 10.81 on the Company's Annual Report on Form 10-K for the year ended December 31, 2006.
10.75	Mediation Settlement Agreement dated as of May 18, 2007, among the Company, Paragon Systems, Inc., Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on May 24, 2007.
10.76	Employment Agreement, dated September 14, 2007, between the Company and John R. Oliver.	Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007.



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10.77	Settlement Agreement and General Release dated September 13, 2007, among the Company, Paragon Systems Inc., Ronald G. Farrell, Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on September 19, 2007.
10.78	Voting Agreement, dated September 13, 2007, among the Company, Ronald G. Farrell, Charles Keathley, Robert Luther, Harold Bright and John Wilson.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on February 7, 2007.
10.79	Amended and Restated Credit Agreement, dated as of December 31, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed on January 7, 2008.
10.80	Loan and Security Agreement, dated as of December 31, 2007, among the Company, its subsidiaries and LSQ Funding Group, L.C.	Incorporated by reference to Exhibit 99.2 to the Company's Current Report on Form 8-K filed on January 7, 2008.
10.81	Supplemental Agreement to Amended and Restated Credit Agreement, dated as of December 31, 2007, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Incorporated by reference to Exhibit 99.3 to the Company's Current Report on Form 8-K filed on January 7, 2008.
10.82	Employment Agreement, dated November 19, 2007, between the Company and Nicolas V. Chater. Represents an executive compensation plan or arrangement.	Filed herewith.
10.83	Amendment and Forbearance, dated as of March 26, 2008, among the Company, its subsidiaries, LSQ Funding Group, L.C. and BRE LLC.	Filed herewith.
21.1	Subsidiaries of the Company.	Filed herewith.
23.1	Consent of Tauber & Balsler, P.C.	Filed herewith.
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Executive Officer.	Filed herewith.
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Financial Officer.	Filed herewith.
32.1	Section 1350 Certification of the Company's Chief Executive Officer.	Filed herewith.
32.2	Section 1350 Certification of the Company's Chief Financial Officer.	Filed herewith.