TRI-S SECURITY CORP
Form 10-Q
May 14, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2008

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**
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	**30-0016962**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

11675 Great Oaks Way, Suite 120, Alpharetta, Georgia 30022

(Address of principal executive offices)

(678) 808-1540

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 x No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

Shares of the registrant s common stock, par value $0.001 per share, outstanding as of May 14, 2008: 4,203,280.

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TRI-S SECURITY CORPORATION

QUARTERLY REPORT ON FORM 10-Q FOR THE

QUARTER ENDED March 31, 2008

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Tri-S Security Corporation and Subsidiaries

Consolidated Balance Sheets

Unaudited

(In thousands, except per share data)

	March 31, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 571	$ 465
Restricted cash	412	348
Unbilled revenues and trade accounts receivable, net of allowance of $750 and $701, respectively	15,912	13,993
Prepaid expenses and other assets	988	353
Total current assets	17,883	15,159
Property and equipment, less accumulated depreciation	763	476
Goodwill	16,078	16,078
Intangibles, net		
Customer contracts	2,243	2,647
Deferred loan costs	398	515
Other	736	769
Total assets	$ 38,101	$ 35,644
Liabilities and Stockholders Equity		
Current liabilities:		
Trade accounts payable	$ 1,884	$ 1,983
Other accrued expenses	1,323	895
Accrued interest expense short term	326	
Accrued salary and benefits	5,661	3,940
Income taxes payable	630	586
Asset-based lending facility	13,085	11,625
10% convertible notes	7,527	7,473
Term loan	2,500	
Long-term debt - current portion		8
Total current liabilities	32,936	26,510
Other liabilities:		
Term loan		2,500
Accrued interest expense - long term	334	353
Series D preferred stock subject to mandatory redemption	1,500	1,500
Total liabilities	34,770	30,863
Stockholders equity:		
Common stock, $0.001 par value, 25,000,000 shares authorized; 4,248,704 shares issued at March 31, 2008 and December 31, 2007	4	4
Treasury stock - 45,424 shares at cost	(105)	(105)
Additional paid-in capital	16,733	16,368
Deficit	(13,301)	(11,486)

Total stockholders equity		3,331		4,781
Total liabilities and stockholders equity	$	38,101	$	35,644

See accompanying notes to financial statements.

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Tri-S Security Corporation and Subsidiaries

Consolidated Statements of Operations

Unaudited

(In thousands, except per share data)

	Three Months Ended March 31,	
	2008	**2007**
Revenues	$ 26,465	$ 20,205
Cost of revenues		
Direct labor	16,466	12,695
Indirect labor and other support costs	7,370	5,251
Amortization of customer contracts	405	406
	24,241	18,352
Gross profit	2,224	1,853
Selling, general and administrative	2,953	2,616
Amortization of intangible assets	176	235
	3,129	2,851
Operating loss	(905)	(998)
Other Income (expense):		
Interest expense	(868)	(458)
Interest on Series C redeemable preferred stock		(75)
Other income	5	550
	(863)	17
Loss before income taxes	(1,768)	(981)
Income tax expense (benefit)	47	(305)
Net loss	$ (1,815)	$ (676)
Basic and diluted net loss per common share	$ (0.43)	$ (0.19)
Basic and diluted weighted average number of common shares	4,203	3,503

See accompanying notes to financial statements.

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Tri-S Security Corporation and Subsidiaries

Consolidated Statements of Cash Flows

Unaudited

(In thousands)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Cash flow from operating activities:		
Net loss	$ (1,815)	$ (676)
Adjustments to reconcile net loss to net cash used by operating activities:		
Gain on Cornwall settlement		(250)
Bad debt expense	50	65
Depreciation and amortization	677	719
Deferred income tax benefits		(179)
Non-cash employee stock option expense	365	76
Non-cash interest expense	54	48
Changes in operating assets and liabilities:		
Unbilled revenues and trade accounts receivable, net	(1,969)	2,324
Prepaid expenses and other assets	(635)	(174)
Trade accounts payable	(99)	(126)
Accrued liabilities	2,448	(83)
Income taxes payable	44	(140)
Net cash (used) provided by operating activities	(880)	1,604
Cash flow from investing activities:		
Increase in restricted cash	(64)	
Purchase of property and equipment	(384)	(12)
Net cash used by investing activities	(448)	(12)
Cash flow from financing activities:		
Net proceeds from (payments on) borrowing facility	1,460	(1,577)
Proceeds of term loans		100
Deferred financing costs	(26)	(40)
Net cash (used) provided by financing activities	1,434	(1,517)
Net increase in cash and cash equivalents	106	75
Cash and cash equivalents at beginning of period	465	66
Cash and cash equivalents at end of period	$ 571	$ 141
Supplemental disclosures of cash flow information:		
Interest paid	$ 571	$ 410
Income taxes paid	$ 4	$ 14

See accompanying notes to financial statements.

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TRI-S SECURITY CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2008

1. Organization

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

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.

In January 2006, Paragon Systems entered into a Joint Venture Agreement with Southeastern Protective Services, Inc. (Southeastern Protective Services) to form Southeastern Paragon (also referred to herein as SEP). Paragon Systems owns 49% and Southeastern Protective Services owns 51% of SEP. Southeastern Paragon was formed to bid on certain contracts, and Paragon Systems manages the contracts awarded to SEP. We account for the results of SEP in accordance with Accounting Principal Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and Financial Accounting Standards Board (FASB) Interpretation No. 46(R) (revised December 2003), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51.*

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 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. Since formation, ODPS has not entered into any contracts.

All significant intercompany transactions have been eliminated.

2. Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (GAAP). The financial statements presented are unaudited and have been prepared by our management in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC). In the opinion of our management, all adjustments, consisting of normal recurring accruals, necessary for the fair presentation of the financial position, results of operations and cash flows have been included. For further information, see our audited financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007 (the Annual Report) filed with the SEC. Disclosure that substantially duplicates the disclosure contained in the footnotes to the audited financial statements included in the Annual Report has been omitted from these notes.

3. 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 promissory notes (the 10% Notes) with an outstanding principal balance of approximately $7.5 million 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% Notes which mature later this year. Management believes these initiatives will contribute toward achieving profitability and alleviating the liquidity issues facing the Company.

4. Stock-based Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS No. 123(R)), using the modified prospective method and, therefore, reflects compensation expense in accordance with the SFAS No. 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates.

In accordance with SFAS No. 123(R), the Company recorded $365,000 and $75,000 of stock-based compensation expense for the three months ended March 31, 2008 and 2007, respectively, related to employee stock options. After recording the expense through March 31, 2008, there remained approximately $482,000 of unrecognized compensation cost related to unvested employee stock options to be recognized over the next two years.

5. Common and Preferred Stock

Immediately prior to the initial public offering of the common stock on February 9, 2005, we entered into an exchange and recapitalization agreement with all of the holders of the outstanding common stock and convertible preferred stock and holders of outstanding rights to acquire the common stock. Pursuant to the agreement, we implemented a reverse stock split of all the outstanding shares of the common stock and stock options and exchanged common stock for all outstanding 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 Paragon Settlement Agreement), among the Company, Paragon Systems, and Ronald G. Farrell, our Chief Executive Officer, on the one hand, and Charles Keathley, Robert Luther, John Wilson and Harold Bright, on the other hand (collectively, the Selling Shareholders), with respect to all of the litigation pending among the Company, Paragon Systems, Mr. Farrell and the Selling Shareholders (collectively, the Litigation). Pursuant to the Paragon Settlement Agreement:

(i) we 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;

(iv) we issued to the Selling Shareholders an aggregate of 700,000 shares of common stock and an aggregate of 100 shares of our 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 which are payable quarterly;

(v) we 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) we 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 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 which had been 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 Paragon Settlement Agreement) and have caused the Litigation to be dismissed with prejudice.

During the first quarter of 2008, the Company granted to Mr. Farrell an option to purchase 400,000 shares of common stock at an exercise price of $2.50 per share, which vests with respect to one-half of the underlying shares on the date of grant and the remaining one-half of the underlying shares on the first anniversary of the date of grant. Pursuant to the Paragon Settlement Agreement and concurrently with the grant to Mr. Farrell, the Company granted to the Selling Shareholders options to purchase an aggregate of 40,000 shares of common stock at an exercise price of $2.50 per share, which options vest on the same schedule as the option granted to Mr. Farrell.

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

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 our Board of Directors. We have never paid any cash dividends on common stock.

6. Debt and Other Obligations

Amended and Restated Credit Agreement

On October 18, 2005, we entered into a Credit Agreement (the Original 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 and $3,500,000 pursuant to a term loan with a maturity date of October 1, 2009. During the second quarter of 2006, these term loans were paid in full.

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

During March 2007, we entered into an Amendment and Forbearance Agreement with our Lenders pursuant to which we amended the Original Credit Agreement and secured an additional $2.5 million term loan with our Lenders to provide additional financing. The term loan matures on March 28, 2009.

On December 31, 2007, we entered into an Amended and Restated Credit Agreement (the Amended and Restated Credit Agreement) with our Lenders, which amends and restates the Original Credit Agreement 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 our Lenders (the Credit Agreement Supplement).

The Amended and Restated Credit Agreement continues to provide for the $2,500,000 term loan to us contemplated by the Original Credit Agreement. Under the Amended and Restated Credit Agreement, interest on the 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 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 term loan requires us to pay a Minimum Balance Fee as described in the Amended and Restated Credit Agreement if the 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 term loan has been repaid in full. Prior to repayment of the 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 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 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.

Under the Credit Agreement Supplement, anytime the 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 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 March 31, 2008 is approximately $15.6 million. Additionally, from time to time during 2008 and 2007, we 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 Amended and Restated 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 with our Lenders pursuant to which the Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forebear from exercising all remedies available to them in connection with such existing defaults until the earlier of the completion of an 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 the 10% Notes, which had an original aggregate principal amount of $8,015,000, and warrants to purchase 834,896 shares of common stock for a total purchase price of $8,015,000. The 10% Notes and warrants were issued in four closings between September 2, 2005 and October 14, 2005. The face value of the 10% Notes 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 received was allocated to the 10% Notes and $1,908,000 of the gross proceeds received 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 of 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 of 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.

7. Income Taxes

We adopted the provisions of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109* (FIN 48), on January 1, 2007. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition 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 quarter ended March 31, 2008 to the balance of unrecognized tax benefits and no material change is expected in the next twelve months. In addition, the following information required by FIN 48 is provided:

As noted above, as of January 1, 2007, we have accrued penalties in the amount of $32,104 related to uncertain tax positions. As of March 31, 2008, the total amount of interest and penalties accrued was $216,745. Accrued interest on tax deficiencies and tax penalties are recorded as a component of income tax expense.