

Edgar Filing: ARGAN INC - Form 10QSB

ARGAN INC  
Form 10QSB  
September 11, 2006

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

FORM 10-QSB

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended July 31, 2006

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT

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

Commission File Number 001-31756

Argan, Inc.

(Exact Name of Small Business Issuer as Specified in Its Charter)

Delaware  
(State or other Jurisdiction of  
Incorporation or Organization)

13-1947195  
(I.R.S. Employer  
Identification No.)

One Church Street, Suite 401, Rockville MD 20850  
(Address of Principal Executive Offices)

(301) 315-0027  
(Issuer's Telephone Number, Including Area Code)

N/A  
(Former Name, Former Address and Former Fiscal Year,  
if Changed Since Last Report)

Check whether the issuer (1) filed all reports required to be filed by  
Section 13 or 15 (d) of the Exchange Act during the past twelve months (or for  
such shorter period that the Registrant was required to file such reports), and  
(2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Common Stock, par value \$.15 per share, outstanding at September 7, 2006:  
4,574,010.

Transitional Small Business Disclosure Format (Check One): Yes  No

ARGAN, INC.

INDEX

Edgar Filing: ARGAN INC - Form 10QSB

|  | Page No. |
|--|----------|
|  | -----    |
| PART I. FINANCIAL INFORMATION .....  | 3        |
| Item 1. Financial Statements (unaudited) .....   | 3        |
| Condensed Consolidated Balance Sheets - July 31, 2006 and<br>January 31, 2006 .....                                | 3        |
| Condensed Consolidated Statements of Operations for the Three and<br>Six Months Ended July 31, 2006 and 2005 ..... | 4        |
| Condensed Consolidated Statements of Cash Flows for the Six Months<br>Ended July 31, 2006 and 2005 .....           | 5        |
| Notes to Condensed Consolidated Financial Statements .....   | 6        |
| Item 2. Management's Discussion and Analysis or Plan of Operation ...  | 18       |
| Item 3. Controls and Procedures .....  | 32       |
| PART II. OTHER INFORMATION .....   | 32       |
| Item 1. Legal Proceedings .....  | 32       |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds..  | 32       |
| Item 3. Defaults Upon Senior Securities .....  | 32       |
| Item 4. Submission of Matters to a Vote of Security Holders .....  | 32       |
| Item 5. Other Information .....  | 32       |
| Item 6. Exhibits .....   | 33       |
| SIGNATURES .....   | 34       |

2

PART . FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

ARGAN, INC.  
Condensed Consolidated Balance Sheets  
(Unaudited)

|   | July 31,<br>2006 | Januar<br>200 |
|---|------------------|---------------|
|   | -----            | -----         |
| ASSETS  |                  |               |
| CURRENT ASSETS:   |                  |               |
| Cash and cash equivalents   | \$ 161,000       | \$            |
| Accounts receivable, net of allowance for doubtful accounts of \$70,000<br>at 7/31/2006 and \$50,000 at 1/31/2006   | 3,888,000        | 3,35          |
| Receivable from affiliated entity   | 148,000          | 15            |
| Escrowed cash   | 300,000          | 30            |
| Estimated earnings in excess of billings  | 581,000          | 67            |
| Inventories, net of reserves of \$95,000 at 7/31/2006 and 1/31/06   | 2,867,000        | 3,41          |
| Prepaid expenses and other current assets   | 782,000          | 45            |
|   | -----            | -----         |
| TOTAL CURRENT ASSETS  | 8,727,000        | 8,35          |
| Property and equipment, net of accumulated depreciation of<br>\$1,878,000 at 7/31/2006 and \$1,418,000 at 1/31/2006 | 3,418,000        | 3,32          |
| Issuance cost for subordinated debt   | --               | 25            |
| Other assets  | 36,000           | 4             |
| Contractual customer relationships, net   | 1,643,000        | 1,89          |
| Trade name  | 224,000          | 22            |
| Proprietary formulas, net   | 497,000          | 72            |
| Non-compete agreement, net  | 1,110,000        | 1,29          |
| Goodwill  | 7,505,000        | 7,50          |

Edgar Filing: ARGAN INC - Form 10QSB

|  |  |               |               |
|--|--|---------------|---------------|
| TOTAL ASSETS   |  | \$ 23,160,000 | \$ 23,620,000 |
| -----  |  |               |               |
| LIABILITIES AND STOCKHOLDERS' EQUITY   |  |               |               |
| CURRENT LIABILITIES:   |  |               |               |
| Accounts payable   |  | \$ 2,962,000  | \$ 3,200,000  |
| Due to affiliates  |  | 13,000        | 12,000        |
| Accrued expenses   |  | 2,288,000     | 1,800,000     |
| Billings in excess of cost and earnings  |  | 7,000         |               |
| Deferred income tax liability  |  | --            | 4,000         |
| Line of credit   |  | 1,343,000     | 1,240,000     |
| Current portion of long-term debt  |  | 113,000       | 420,000       |
| -----  |  |               |               |
| TOTAL CURRENT LIABILITIES  |  | 6,726,000     | 6,840,000     |
| Deferred income tax liability  |  | 1,421,000     | 1,610,000     |
| Deferred rent  |  | 13,000        | 1,000         |
| Long-term debt   |  | 132,000       | 170,000       |
| Subordinated note due former owner of Vitarich Laboratories, Inc.  |  | 1,492,000     | 3,290,000     |
| -----  |  |               |               |
| TOTAL LIABILITIES  |  | 9,784,000     | 11,930,000    |
| -----  |  |               |               |
| STOCKHOLDERS' EQUITY   |  |               |               |
| Preferred stock, par value \$.10 per share - 500,000 shares authorized-<br>issued - none   |  | --            | --            |
| Common stock, par value \$.15 per share -<br>12,000,000 shares authorized - 4,577,243 and 3,817,243 shares<br>issued at 7/31/2006 and 1/31/2006 and 4,574,010 and 3,814,010<br>Shares outstanding at 7/31/2006 and 1/31/2006 |  | 686,000       | 570,000       |
| Warrants outstanding   |  | 849,000       | 840,000       |
| Additional paid-in capital   |  | 27,085,000    | 25,330,000    |
| Accumulated deficit  |  | (15,211,000)  | (15,030,000)  |
| Treasury stock at cost: - 3,233 shares at 7/31/2006 and 1/31/2006  |  | (33,000)      | (30,000)      |
| -----  |  |               |               |
| TOTAL STOCKHOLDERS' EQUITY   |  | 13,376,000    | 11,680,000    |
| -----  |  |               |               |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY   |  | \$ 23,160,000 | \$ 23,620,000 |
| =====  |  |               |               |

See Accompany Notes

3

ARGAN, INC.  
Condensed Consolidated Statements of Operations  
(Unaudited)

|                                 | Three months ended July 31, |              | Six months ended July 31, |              |
|---------------------------------|-----------------------------|--------------|---------------------------|--------------|
|                                 | 2006                        | 2005         | 2006                      | 2005         |
|                                 | -----                       |              | -----                     |              |
| Net sales                       |                             |              |                           |              |
| Nutraceutical products          | \$5,211,000                 | \$ 4,524,000 | \$11,040,000              | \$ 9,252,000 |
| Telecom infrastructure services | 3,349,000                   | 2,328,000    | 6,482,000                 | 4,756,000    |
|                                 | -----                       |              | -----                     |              |
| Net sales                       | 8,560,000                   | 6,852,000    | 17,522,000                | 14,008,000   |

Edgar Filing: ARGAN INC - Form 10QSB

|   |              |                |              |                |
|---|--------------|----------------|--------------|----------------|
| Cost of sales   |              |                |              |                |
| Nutraceutical products  | 3,940,000    | 3,559,000      | 8,326,000    | 6,989,000      |
| Telecom infrastructure services                                       | 2,678,000    | 1,932,000      | 5,001,000    | 3,839,000      |
|   | -----        | -----          | -----        | -----          |
| Gross profit  | 1,942,000    | 1,361,000      | 4,195,000    | 3,180,000      |
| Selling, general and administrative expenses                          | 1,944,000    | 1,986,000      | 3,920,000    | 3,826,000      |
|   | -----        | -----          | -----        | -----          |
| (Loss) income from operations   | (2,000)      | (625,000)      | 275,000      | (646,000)      |
| Interest expense and amortization of subordinated debt issuance costs | 216,000      | 103,000        | 477,000      | 159,000        |
| Other (income) expense, net   | (1,000)      | 1,952,000      | (3,000)      | 1,925,000      |
|   | -----        | -----          | -----        | -----          |
| Loss from operations before income taxes                              | (217,000)    | (2,680,000)    | (199,000)    | (2,730,000)    |
| Income tax benefit  | 62,000       | 294,000        | 26,000       | 322,000        |
|   | -----        | -----          | -----        | -----          |
| Net loss  | \$ (155,000) | \$ (2,386,000) | \$ (173,000) | \$ (2,408,000) |
|   | =====        | =====          | =====        | =====          |
| Basic and diluted loss per share                                      | \$ (0.03)    | \$ (0.76)      | \$ (0.04)    | \$ (0.79)      |
|   | =====        | =====          | =====        | =====          |
| Weighted average number of shares outstanding - basic and diluted     | 4,549,000    | 3,136,000      | 4,181,000    | 3,064,000      |
|   | =====        | =====          | =====        | =====          |

See Accompany Notes

4

ARGAN, INC.  
Condensed Consolidated Statements of Cash Flows  
(unaudited)

|   | Six Months Ended<br>July 31, |                |
|---|------------------------------|----------------|
|   | -----<br>2006                | 2005<br>-----  |
| CASH FLOWS FROM OPERATING ACTIVITIES:   |                              |                |
| Net loss  | \$ (173,000)                 | \$ (2,408,000) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |                              |                |
| Depreciation  | 518,000                      | 390,000        |
| Amortization of debt issuance costs   | 257,000                      | 32,000         |
| Amortization of purchase intangibles  | 660,000                      | 848,000        |
| Deferred income taxes   | (246,000)                    | (322,000)      |
| Non-cash loss on liability for derivative financial instruments                 | --                           | 1,930,000      |
| Gain on sale of property and equipment  | 8,000                        | --             |
| Non-cash stock option compensation expense                                      | 80,000                       | --             |
| Changes in operating assets and liabilities:                                    |                              |                |
| Accounts receivable, net  | (537,000)                    | (456,000)      |
| Receivable from affiliated entity   | 9,000                        | (18,000)       |
| Estimated earnings in excess of billings  | 94,000                       | (128,000)      |
| Inventories, net  | 543,000                      | 811,000        |
| Prepaid expenses and other current assets                                       | (337,000)                    | (39,000)       |

4

## Edgar Filing: ARGAN INC - Form 10QSB

|   |             |             |
|---|-------------|-------------|
| Accounts payable and accrued expenses   | 164,000     | 33,000      |
| Billings in excess of estimated earnings  | 7,000       | --          |
| Due to affiliates   | (108,000)   | 69,000      |
| Other   | 14,000      | 12,000      |
|   | -----       | -----       |
| Net cash provided by operating activities   | 953,000     | 754,000     |
|   | -----       | -----       |
| CASH FLOWS FROM INVESTING ACTIVITIES:   |             |             |
| Purchases of property and equipment   | (612,000)   | (793,000)   |
| Purchase of Vitarich Laboratories, Inc.   | --          | (270,000)   |
| Proceeds from sale of property and equipment  | 4,000       | --          |
|   | -----       | -----       |
| Net cash used in investing activities   | (608,000)   | (1,063,000) |
|   | -----       | -----       |
| CASH FLOWS FROM FINANCING ACTIVITIES:   |             |             |
| Proceeds from escrow cash   | --          | 304,000     |
| Net proceeds from sale of stock   | 1,863,000   | --          |
| Proceeds from line of credit  | 2,855,000   | 1,500,000   |
| Proceeds from long-term debt  | --          | 8,000       |
| Payments on line of credit  | (2,755,000) | (1,148,000) |
| Principal payments on long-term debt  | (352,000)   | (398,000)   |
| Principal payments on subordinated note due former owner of Vitarich Laboratories, Inc. | (1,800,000) | --          |
|   | -----       | -----       |
| Net cash (used in) provided by financing activities                                     | (189,000)   | 266,000     |
|   | -----       | -----       |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                                    | 156,000     | (43,000)    |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD  | 5,000       | 167,000     |
|   | -----       | -----       |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD  | \$ 161,000  | \$ 124,000  |
|   | =====       | =====       |

See Accompany Notes

5

ARGAN, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1- ORGANIZATION

NATURE OF OPERATIONS

Argan, Inc. ("AI" or the "Company") conducts its operations through its wholly owned subsidiaries Vitarich Laboratories, Inc. ("VLI") which it acquired in August 2004 and Southern Maryland Cable, Inc. ("SMC") which it acquired in July 2003. Through VLI, the Company develops, manufactures and distributes premium nutritional supplements, whole-food dietary supplements and personal care products. Through SMC, the Company provides telecommunications infrastructure services including project management, construction and maintenance to the Federal Government, telecommunications and broadband service providers, as well as electric utilities primarily in the Mid-Atlantic region.

AI operates in two reportable segments. (See Note 9)

MANAGEMENT'S PLANS, LIQUIDITY AND BUSINESS RISKS

## Edgar Filing: ARGAN INC - Form 10QSB

As of July 31, 2006, the Company had an accumulated deficit of approximately \$15 million. At July 31, 2006, the Company had approximately \$2.9 million available under its revolving line of credit with the Bank of America, N.A. (the Bank). The Company operates in two distinct and separate reportable segments. The market for nutritional products is highly competitive and the telecom and infrastructure services industry is fragmented, but also very competitive. The successful execution of the Company's business plan is dependent upon the Company's ability to integrate acquired businesses and their related assets into its operations, its ability to increase and retain its customers, the ability to maintain compliance with significant government regulation, the ability to attract and retain key employees and the Company's ability to manage its growth and expansion, among other factors.

On May 4, 2006, the Company completed a private offering of 760,000 shares of common stock at a price of \$2.50 per share for aggregate proceeds of \$1.9 million. The Company used \$1.8 million of the proceeds to pay down an equal notional amount of the subordinated note due the former owner of VLI. The remainder of the proceeds were used for general corporate purposes. One of the investors, MSRI SBIC, L.P., which acquired 240,000 shares in the offering, is controlled by Daniel Levinson, a director of the Company. In addition, James Quinn, a director of the Company acquired 40,000 shares for his own account. (See Notes 5 and 7)

On May 5, 2006, the Company renewed its line of credit with the Bank, extending the maturity date to May 31, 2007. Concurrent with the renewal, the Bank has agreed to provide a new \$1.5 million term loan facility (New Term Loan) designed to refinance the subordinated note with the former owner of VLI that had an outstanding balance of \$1,492,000 at July 31, 2006. The Company must be in compliance with its debt covenants to draw on the New Term Loan. (See Note 6)

The financing arrangement with the Bank requires the Company to comply with certain financial covenants. At January 31, 2006, the Company failed to comply with financial covenants requiring that the ratio of debt to pro forma earnings before interest, taxes, depreciation and amortization not exceed 2.5 to 1 and requiring a pro forma fixed charge coverage ratio of not less than 1.25 to 1. The Bank waived the failure for the measurement period ended January 31, 2006. For future measurement periods, the Bank revised the definitions of certain components of the financial covenants to specifically exclude the impact of VLI's impairment loss at January 31, 2006.

6

The subordinated debt due the former owner of VLI was originally due on August 1, 2006. On May 5, 2006, the Company entered into an agreement with the former owner of VLI to delay the timing of the payment on the subordinated debt to August 1, 2007. On August 31, 2006, the Company borrowed \$1.5 million under the New Term Loan and paid the remaining principal and interest due on the subordinated note with Thomas. (See Note 6)

Management believes that capital resources available under its renewed line of credit combined with cash generated from the Company's operations is adequate to meet the Company's future operating cash needs. Accordingly, the carrying value of the assets and liabilities in the accompanying balance sheet do not reflect any adjustments should the Company be unable to meet its future operating cash needs in the ordinary course of business. The Company continues to take various actions to align its cost structure to appropriately match its expected revenues, including limiting its operating expenditures and controlling its capital expenditures. Any future acquisitions, other significant unplanned costs or cash requirements may require the Company to raise additional funds through

## Edgar Filing: ARGAN INC - Form 10QSB

the issuance of debt and equity securities. There can be no assurance that such financing will be available on terms acceptable to the Company, or at all. If additional funds are raised by issuing equity securities, significant dilution to the existing stockholders may result.

### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - The condensed consolidated balance sheet as of July 31, 2006, the condensed consolidated statements of operations for the three and six months ended July 31, 2006 and 2005, and the statements of cash flows for the six month period ended July 31, 2006 and 2005, are unaudited. In the opinion of management, the accompanying financial statements contain all adjustments, which are of a normal and recurring nature, considered necessary to present fairly the financial position of the Company as of July 31, 2006 and the results of its operations and its cash flows for the interim periods presented. The Company prepares its interim financial information using the same accounting principles as it does for its annual financial statements.

These financial statements do not include all disclosures associated with annual financial statements and, accordingly, should be read in conjunction with the footnotes contained in the Company's consolidated financial statements for the year ended January 31, 2006, together with the independent registered public accounting firm's report, included in the Company's Annual Report on Form 10-KSB, as filed with the Securities and Exchange Commission (SEC). The results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

Reclassifications - Certain amounts in the prior year financial statements have been reclassified to conform with the presentation in the current year financial statements.

Inventories - Inventories are stated at the lower of cost or market (net realizable value). Cost is determined on the first-in, first-out (FIFO) method. Appropriate consideration is given to obsolescence, excessive inventory levels, product deterioration, and other factors in evaluating net realizable value.

Inventories consist of the following:

|                  | July 31, 2006 | January 31, 2006 |
|------------------|---------------|------------------|
|                  | -----         | -----            |
| Raw materials    | \$2,544,000   | \$3,190,000      |
| Work-in process  | 314,000       | 70,000           |
| Finished goods   | 104,000       | 245,000          |
| Less: Reserves   | (95,000)      | (95,000)         |
|                  | -----         | -----            |
| Inventories, net | \$2,867,000   | \$3,410,000      |
|                  | =====         | =====            |

The Company entered into an agreement with one of its major customers, whereby the customer made an advanced payment to the Company for a significant portion of raw material at cost. The raw material is held at the Company's premises and is used in the production of a product for the customer. The Company is accounting for this as an inventory financing arrangement and recognizes revenue from the sale of the raw material when the finished product is shipped to the customer. At July 31, 2006, the Company had customer deposits and inventories related to this arrangement of \$466,000.

## Edgar Filing: ARGAN INC - Form 10QSB

Earnings Per Share - Income per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Dilutive earnings per share represent net income divided by the weighted average number of common shares outstanding inclusive of the effects of dilutive securities. Outstanding stock options and warrants for the purchase of 5,000 shares of common stock were not included in the weighted average shares outstanding during the three and six months ended July 31, 2006, because they are antidilutive.

Seasonality - The Company's telecom infrastructure services operations are expected to have seasonally weaker results in the first and fourth quarters of our year, and may produce stronger results in the second and third quarters. This seasonality is primarily due to the effect of winter weather on outside plant activities as well as reduced daylight hours and customer budgetary constraints. Certain customers tend to complete budgeted capital expenditures before the end of the year, and postpone additional expenditures until the subsequent fiscal period.

Stock Option Plans - Prior to February 1, 2006, the Company measured compensation costs for stock based compensation plans using the intrinsic value method of accounting as prescribed in Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB No. 25") and related interpretations. In electing to follow APB No. 25 for expense recognition purposes for the three and six months ended July 31, 2005, the Company has provided below the expanded disclosures required under Statement of Financial Accounting Standards No. 148 "Accounting for Stock Based Compensation" ("SFAS No. 148") for stock-based compensation granted including, if materially different from reported results, disclosure of pro forma net income and net income per share had compensation expense relating to grants been measured under the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). All options issued and outstanding at July 31, 2005 had an exercise price greater than the market price of the Company's stock on the date of grant. The fair values of options granted have been estimated at the date of grant using a Black-Scholes option-pricing model. Option valuation models require the use of subjective assumptions and changes in these assumptions can materially impact the fair value of the options.

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to options granted and unvested under the Plan for the three and six months ended July 31, 2005. For purposes of this pro forma disclosure, the value of options is estimated using a Black-Scholes option-pricing formula and amortized over the options' vesting periods.

8

### Pro Forma Disclosures

|   | Six months<br>ended July 31,<br>2005 | Three months<br>ended July 31,<br>2005 |
|---|--------------------------------------|--|
|   | -----                                | -----                                  |
| Net loss, as reported   | \$(2,408,000)                        | \$(2,386,000)                          |
| Deduct: Total stock-based employee<br>compensation expense determined<br>under fair value based methods | 43,000                               | 23,000                                 |
|   | -----                                | -----                                  |
| Pro forma net loss  | \$(2,451,000)                        | \$(2,409,000)                          |
|   | =====                                | =====                                  |
| Basic and diluted per share:  |                                      |  |



## Edgar Filing: ARGAN INC - Form 10QSB

|                                 |           |           |
|---------------------------------|-----------|-----------|
| Basic and diluted - as reported | \$ (0.79) | \$ (0.76) |
|                                 | =====     | =====     |
| Basic and diluted - pro forma   | \$ (0.80) | \$ (0.77) |
|                                 | =====     | =====     |

### Impact of Changes in Accounting Standards

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 ("FIN 48"), which clarifies the accounting for uncertainty in income tax positions. FIN 48 requires that the Company recognize in the consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. The provisions of FIN 48 will be effective for the Company, as of the beginning of the Company's fiscal year ending January 31, 2008, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on the consolidated financial statements.

### NOTE 3 - STOCK BASED COMPENSATION

At July 31, 2006, the Company has a stock option plan which was established in August 2001 (Plan). Under the Plan, the Company's Board of Directors may grant stock options to officers, directors and key employees. The Plan was amended in April 2003 to authorize the grant of options for up to 250,000 shares of common stock.

Prior to February 1, 2006, the Company accounted for the Plan under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees ("APB No. 25"), and related interpretations, as permitted by Statements of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock Based Compensation ("SFAS No. 123)". No stock-based employee compensation cost was recognized in the Statement of Operations for the three and six months ended July 31, 2005, as all options granted under the Plan had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. Effective February 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based Payment" (SFAS No. 123(R)), using the modified-prospective transition method. Under that transition method, compensation cost recognized in the six months ended July 31, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of February 1, 2006, based on grant date fair value estimated in accordance with the original provisions of SFAS No. 123 and (b) compensation cost for all share-based payments granted on or subsequent to February 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated.

As a result of adopting SFAS No. 123(R) on February 1, 2006, the Company's loss before income taxes for the six and three months ended July 31, 2006, was approximately \$80,000 and \$69,000, respectively, more than if it had continued to account for share based compensation under APB No. 25. Basic and diluted loss per share for the six and three months ended July 31, 2006 would have been \$0.02 more than if it had continued to account for share based compensation under APB No. 25.

Stock options granted may be "Incentive Stock Options" ("ISOs") or "Nonqualified

## Edgar Filing: ARGAN INC - Form 10QSB

Stock Options" (NSOs"). ISOs have an exercise price at least equal to the stock's fair market value at the date of grant, a ten-year term and vest and become fully exercisable one year from the date of grant. NSOs may be granted at an exercise price other than the stock's fair market value at the date of grant and have up to a ten-year term, and vest and become fully exercisable as determined by the Board.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option-pricing formula that uses the assumptions noted in the table and discussion that follows:

|                         | Six Months Ended July 31, |       |
|-------------------------|---------------------------|-------|
|                         | 2006                      | 2005  |
| Dividend yield          | --                        | --    |
| Expected volatility     | 57%                       | 56%   |
| Risk-free interest rate | 5.11%                     | 4.16% |
| Expected life in years  | 5                         | 5     |

A summary of option activity under the Plan as of July 31, 2006, and changes in the six months then ended is presented below:

| Options                                     | Shares  | Weighted-Average Exercise Price | Weighted-Average Remaining Contract Term | Aggregate Intrinsic Value |
|---|---------|---------------------------------|--|---------------------------|
| Outstanding at beginning of period          | 73,000  | \$7.84                          |  |                           |
| Granted                                     | 160,000 | \$2.49                          |  |                           |
| Exercised                                   | --      |                                 |  |                           |
| Forfeited or expired                        | (3,000) | \$7.76                          |  |                           |
| Outstanding at end of period                | 230,000 | \$4.12                          | 8.6                                      | \$423,000                 |
| Vested or expected to vest at end of period | 230,000 | \$4.12                          | 8.6                                      | \$423,000                 |
| Exercisable at end of period                | 62,200  | \$7.85                          | 6.0                                      | \$200,000                 |

The weighted average grant date fair value of options granted during the six months ended July 31, 2006 and 2005 was \$1.34 and \$2.78, respectively.

No options were exercised during the six months ended July 31, 2006 and 2005. At July 31, 2006, there was \$149,000 of total unrecognized compensation cost related to stock options granted under the Plan. That cost is expected to be recognized over the next six months which represents the six month vesting period of options granted. The total fair value of shares vested during the six months ended July 31, 2006 and 2005, was \$62,000 and \$19,000, respectively.

A summary of the status of the Company's nonvested shares as of July 31, 2006, and changes during the six months then ended, is present below:

|                                  | Shares  | Aggregate Intrinsic Value |
|----------------------------------|---------|---------------------------|
| Nonvested at beginning of period | 16,000  | \$1.95                    |
| Granted                          | 160,000 | \$1.34                    |

Edgar Filing: ARGAN INC - Form 10QSB

|                            |         |        |
|----------------------------|---------|--------|
| Vested                     | (8,000) | \$2.78 |
| Forfeited                  | (3,000) | \$2.25 |
|                            | -----   |        |
| Nonvested at end of period | 165,000 | \$1.33 |
|                            | =====   |        |

10

The fair value of nonvested shares is determined based on the opening trading price of the Company's shares on the grant date.

In connection with the Company's private placement in April 2003, the Company issued warrants to purchase shares of the Company's common stock at a price of \$7.75 per share with a ten year term. 180,000 of the warrants were granted to three individuals who became the executive officers of the Company upon completion of the offering. In addition, MSR Advisors, Inc. (MSR) received warrants to purchase 50,000 shares of the Company's stock. A director of the Company is the Chief Executive Officer of MSR. The fair value of the warrants of \$849,000 was recognized as offering costs. All warrants are exercisable.

At July 31, 2006, there were 460,000 shares of the Company's common stock reserved for issuance upon exercise of stock options and warrants.

NOTE 4- SUMMARY OF INTANGIBLE ASSETS

The Company's intangible assets consist of the following at July 31, 2006.

|  | Estimated<br>Useful Life | Gross Carrying<br>Amount | Accumulated<br>Amortization | SMC<br>Impairment<br>Loss (1) | VLI<br>Impairment<br>Loss (2) | Net   |
|--|--------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------|-------|
|  | -----                    | -----                    | -----                       | -----                         | -----                         | ---   |
| Goodwill                                 | Indefinite               | \$14,055,000 (3)         | \$ --                       | \$ 740,000 (1)                | \$5,810,000 (2)               | \$ 7  |
| Contractual<br>Customer<br>Relationships | 5-7 years                | 3,600,000                | 1,211,000                   | 746,000 (1)                   | --                            | 1     |
| Proprietary<br>Formulas                  | 3 years                  | 2,500,000                | 1,316,000                   | --                            | 687,000 (2)                   |       |
| Non-Compete<br>Agreement                 | 5 years                  | 1,800,000                | 690,000                     | --                            | --                            | 1     |
| Trade Name                               | Indefinite               | 680,000                  | --                          | 456,000 (1)                   | --                            |       |
|  |                          | -----                    | -----                       | -----                         | -----                         | ---   |
|  |                          | \$22,635,000             | \$3,217,000                 | \$1,942,000 (1)               | \$6,497,000 (2)               | \$10  |
|  |                          | =====                    | =====                       | =====                         | =====                         | ===== |

(1) During the twelve months ended January 31, 2005, the Company recorded an impairment loss with respect to goodwill and intangibles at SMC.

(2) During the twelve months ended January 31, 2006, the Company recorded an impairment loss with respect to goodwill and proprietary formulas at VLI.

(3) Amounts recorded as goodwill are not deductible for tax reporting purposes.

Amortization expense for the six months ended July 31, 2006, aggregated \$251,000, \$229,000 and \$180,000 for Contractual Customer Relationships, Proprietary Formulas and Non-Compete Agreement, respectively. Amortization

## Edgar Filing: ARGAN INC - Form 10QSB

expense for the six months ended July 31, 2005, aggregated \$231,000, \$417,000 and \$200,000 for Contractual Customer Relationships, Proprietary Formulas and Non-Compete Agreement, respectively.

### NOTE 5 - RELATED PARTY TRANSACTIONS

On May 4, 2006, the Company completed a private offering of 760,000 shares of common stock at a price of \$2.50 per share for aggregate proceeds of \$1.9 million. These shares were registered with the SEC effective July 10, 2006. The Company used \$1.8 million of the proceeds to pay down an equal notional amount of the subordinated note due Kevin Thomas ("Thomas"). The remainder of the proceeds were used for general corporate purposes.

11

One of the investors, MSRI SBIC, L.P., which acquired 240,000 shares in the offering, is controlled by Daniel Levinson, a director of the Company. In addition, James Quinn, a director of the Company acquired 40,000 shares for his own account.

On January 28, 2005, the Company sold and issued to MSR I SBIC, L.P., a Delaware limited partnership ("Investor"), 129,032 shares of common stock of the Company pursuant to a Subscription Agreement between the Company and Investor ("Subscription Agreement"). These Shares were issued at a purchase price of \$7.75 per share, yielding aggregate proceeds of \$999,998. (See Note 7) These Shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. The Investor is an entity controlled by Daniel Levinson, a director of the Company.

Pursuant to the Subscription Agreement, the Company agreed to issue additional shares of the Company's common stock to Investor in accordance with the Subscription Agreement under certain conditions upon the earlier of (i) the Company's issuance of additional shares of common stock having an aggregate purchase price of at least \$2,500,000, at a price per share less than \$7.75 subject to certain exclusions, or (ii) ninety percent of the average bid price of the Company's common stock for the thirty days ended July 31, 2005 if the price was less than \$7.75, less the 129,032 shares previously issued. The Company settled the liability for issuance of additional shares in a non-cash transaction at July 31, 2005 with the issuance of 95,321 shares of the Company's common stock.

The provision in the Subscription Agreement which allows the Investor to receive additional shares under certain conditions represents a derivative under Statement of Financial Accounting Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities." Accordingly, \$139,000 of the proceeds received at issuance was accounted for as a liability for a derivative financial instrument. This liability relates to the obligation to issue Investor additional shares under certain conditions. The derivative financial instrument was subject to adjustment for changes in fair value subsequent to issuance. During the three and six months ended July 31, 2005, the Company recorded a fair value loss adjustment of \$344,000 and \$343,000, respectively, which is recorded in other expense (income), net.

On January 31, 2005, the Company entered into a debt subordination agreement with Thomas, the former owner of VLI, for the cash portion of the additional consideration the Company owes Thomas. The subordinated debt had an original maturity of August 1, 2006 and had an interest rate of 10%. On May 5, 2006, the Company entered into an extension with Thomas of the maturity date of the subordinated note to August 1, 2007. The remaining principal and interest due on

## Edgar Filing: ARGAN INC - Form 10QSB

this note was paid on August 31, 2006.

At issuance, \$501,000 of the charge related to the liability for derivative financial instruments was recorded as deferred issuance cost for subordinated debt which will be amortized over the life of the subordinated debt. The amortization of the deferred loan issuance cost increases the Company's interest expense through August 1, 2007, the maturity date of the note, and reduces net income. The derivative financial instrument was subject to adjustment for changes in fair value subsequent to issuance. The fair value adjustment of a \$1,609,000 and \$1,587,000 gain during the six and three months ended July 31, 2005, respectively, was reflected as a change in liability for the derivative financial instruments and as a credit to the Company's other expense (income), net. The liability for the derivative financial instrument was settled as a non-cash transaction by the issuance of 535,052 shares of the Company's common stock on September 1, 2005.

The Company leases administrative, manufacturing and warehouse facilities for various lengths of time from individuals who are officers of SMC and VLI. The total expense under these arrangements was \$64,000 and \$140,000 for the three and six months ended July 31, 2006, respectively, and \$78,000 and \$147,000 for the three and six months ended July 31, 2005, respectively.

The Company has also entered into a supply agreement with an entity owned by the former shareholder of VLI whereby the supplier committed to sell to the Company and the Company committed to purchase on an as-needed basis, certain organic products. VLI made \$38,000 and \$55,000 in purchases under the supply agreement during the three and six months ended July 31, 2006, respectively, and \$55,000 and \$79,000 for the three and six months ended July 31, 2005, respectively.

The Company also sells its products in the normal course of business to an entity in which the former owner of VLI has an ownership interest. VLI had approximately \$157,000 and \$286,000 in sales with this entity for three and six months ended July 31, 2006, respectively, and \$152,000 and \$301,000 for the three and six months ended July 31, 2005, respectively. At July 31, 2006 and January 31, 2006, the affiliated entity owed \$148,000 to VLI.

12

### NOTE 6 - DEBT

In May 2006, the Company agreed to amend the existing financing arrangements with the Bank of America (Bank). Under this arrangement, the Company has a revolving line of credit of \$4.25 million in maximum availability and a term loan with an original balance of \$1.2 million. The May 2006 amendment extended the expiration of the revolving line of credit to May 31, 2007. Under the amended financing arrangements, amounts outstanding under the revolving line of credit and the three year term note bear interest at LIBOR plus 3.25% and 3.45%, respectively. Availability on a monthly basis under the revolving line is determined by reference to accounts receivable and inventory on hand which meet certain Bank criteria (Borrowing Base). The aforementioned term note was paid on July 31, 2006. At July 31, 2006 and January 31, 2006, the Company had \$1,343,000 and \$1,243,000, respectively, outstanding under the revolving line of credit and an effective interest rate of 8.7% and 7.74%, respectively, with \$2.9 million of additional availability under its Borrowing Base.

The amended financing arrangements provides for a new \$1.5 million term loan facility (New Term Loan). The proceeds of the New Term Loan are designated to refinance the subordinated note with Thomas that at July 31, 2006 and January 31, 2006 had an outstanding balance of \$1,492,000 and \$3,292,000, respectively.

## Edgar Filing: ARGAN INC - Form 10QSB

Advances under the New Term Loan are subject to the Company being in compliance with its debt covenants with the Bank. The New Term Loan will be repaid in thirty-six equal monthly principal payments and bears interest at LIBOR plus 3.25%. On August 31, 2006, the Company borrowed \$1.5 million under the New Term Loan and paid the remaining principal and interest due on the subordinated note with Thomas. As a result of this draw, the Company's Borrowing Base will be reduced by \$750,000 for maximum availability under the revolving line of credit.

The financing arrangements provide for the measurement at the Company's fiscal year end and at each of the Company's fiscal quarter ends of certain financial covenants including requiring that the ratio of debt to pro forma earnings before interest, taxes, depreciation and amortization (EBITDA) not exceed 2.5 to 1 and requiring a pro forma fixed charge coverage ratio of not less than 1.25 to 1. The amended financings also require that the Company meet minimum EBITDA covenants equal to or exceeding (on a trailing twelve months) \$1.2 million for July 31, 2006, \$1.3 million for October 31, 2006 and \$1.8 million for January 31, 2007 and for each successive quarter end thereafter. The Bank's consent continues to be required for acquisitions and divestitures. The Company continues to pledge the majority of the Company's assets to secure the financing arrangements.

13

The amended financing arrangement contains a subjective acceleration clause which allows the Bank to declare amounts outstanding under the financing arrangements due and payable if certain material adverse changes occur. We believe that we will continue to comply with our financial covenants under our financing arrangement. If our performance does not result in compliance with any of our financial covenants, or if the Bank seeks to exercise its rights under the subjective acceleration clause referred to above, we would seek to modify our financing arrangement, but there can be no assurance that the Bank would not exercise their rights and remedies under our financing arrangement including accelerating payment of all outstanding senior and subordinated debt due and payable.

At July 31, 2006, the Company was in compliance with the covenants of its amended financing arrangements.

### NOTE 7 - PRIVATE OFFERINGS OF COMMON STOCK

On May 4, 2006, the Company completed a private offering of 760,000 shares of common stock at a price of \$2.50 per share for aggregate proceeds of \$1.9 million. These shares were registered with the SEC effective July 10, 2006. The Company used \$1.8 million of the proceeds to pay down an equal notional amount of the subordinated note due Kevin Thomas. The remainder of the proceeds were used for general corporate purposes.

One of the investors, MSRI SBIC, L.P., which acquired 240,000 shares in the offering, is controlled by Daniel Levinson, a director of the Company. In addition, James Quinn, a director of the Company acquired 40,000 shares for his own account.

On January 28, 2005, the Company sold and issued to MSR I SBIC, L.P., a Delaware limited partnership ("Investor"), 129,032 shares of the Company's common stock, pursuant to a Subscription Agreement between the Company and Investor ("Subscription Agreement"). These shares were issued at a purchase price of \$7.75 per share, yielding aggregate proceeds of \$999,998. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. The Investor is an entity controlled by Daniel Levinson, a

## Edgar Filing: ARGAN INC - Form 10QSB

director of the Company. (See Note 5) Pursuant to the Subscription Agreement, the Company has agreed to issue additional shares of the Company's common stock to Investor in accordance with the Subscription Agreement based upon the earlier of (i) the Company's issuance of additional shares of common stock having an aggregate purchase price of at least \$2,500,000 at a price per share less than \$7.75, or (ii) July 31, 2005. The additional shares of common stock to be issued would equal the price paid by Investor divided by the lower of (i) the weighted average of all stock sold by the Company prior to July 31, 2005 or; (ii) ninety percent of the average bid price of the Company's common stock for the thirty days ended July 31, 2005 if the price was less than \$7.75, less the 129,032 shares previously issued. The Company settled the liability for issuance of additional shares in a non-cash transaction at July 31, 2005 with the issuance of 95,321 shares of the Company's common stock.

The provision in the Subscription Agreement which allows the Investor to receive additional shares under certain conditions represents a derivative under Statement of Financial Accounting Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities." Accordingly, at January 31, 2005, \$139,000 of the proceeds was accounted for as a liability for a derivative financial instrument. This liability related to the obligation to issue Investor additional shares under certain conditions. The derivative financial instrument was subject to adjustment for changes in fair value subsequent to issuance. During the three and six months ended July 31, 2005, the Company recorded a fair loss value loss adjustment of \$344,000 and \$343,000, respectively, which is recorded in other expense (income), net.

14

### NOTE 8 - INCOME TAXES

The Company had an effective income tax benefit rate of 13% and 29% for the six and three months ended July 31, 2006 and an effective income tax benefit rate of 12% and 11% for the six and three months ended July 31, 2005. During the six and three months ended July 31, 2006, the Company's effective income tax benefit rate decreased by the impact of the amortization of issuance cost for subordinated debt which is treated as a permanent difference for income tax reporting purposes. This permanent difference reduced the effective income tax benefit rate from 38%. During the six and three months ended July 31, 2005, the Company recorded the change in fair value of the liability for derivative financial instruments as other expense which is treated as a permanent difference for income tax reporting purposes. This permanent difference reduced the income tax benefit rate from 38%.

### NOTE 9 - SEGMENT REPORTING

The Company has two reportable operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and assessing performance.

The Company's two operating segments are nutraceutical products and telecom infrastructure services. The Company conducts its operations through its wholly owned subsidiaries - VLI and SMC. The "Other" column includes the Company's corporate and unallocated expenses.

The Company's operating segments are organized in separate business units with different management, customers, technology and services. The respective segments account for the respective businesses using the accounting policies in

## Edgar Filing: ARGAN INC - Form 10QSB

Note 2 to the Company's Form 10-KSB and Note 2 in this filing. Summarized financial information concerning the Company's operating segments is shown in the following tables:

|   | For the Six Months Ended July 31, 2006 |                                       |                |              |
|---|--|---------------------------------------|----------------|--------------|
|   | Nutraceutical<br>Products              | Telecom<br>Infrastructure<br>Services | Other          | Consolidate  |
| Net sales   | \$11,040,000                           | \$6,482,000                           | \$ --          | \$17,522,000 |
| Cost of sales   | 8,326,000                              | 5,001,000                             | --             | 13,327,000   |
| Gross profit  | 2,714,000                              | 1,481,000                             | --             | 4,195,000    |
| Selling, general and administrative expenses                          | 2,157,000                              | 838,000                               | 925,000        | 3,920,000    |
| Income (loss) from operations   | 557,000                                | 643,000                               | (925,000)      | 275,000      |
| Interest expense and amortization of subordinated debt issuance costs | 208,000                                | 29,000                                | 240,000        | 477,000      |
| Other income, net   | --                                     | 3,000                                 | --             | 3,000        |
| Income (loss) before income taxes                                     | \$ 349,000                             | \$ 617,000                            | \$ (1,165,000) | (199,000)    |
| Income tax benefit  |  |                                       |                | 26,000       |
| Net loss  |  |                                       |                | \$ (173,000) |
| Depreciation and amortization   | \$ 273,000                             | \$ 231,000                            | \$ 271,000     | \$ 775,000   |
| Amortization of intangibles   | \$ 609,000                             | \$ 51,000                             | \$ --          | \$ 660,000   |
| Goodwill  | \$ 6,565,000                           | \$ 940,000                            | \$ --          | \$ 7,505,000 |
| Total assets  | \$17,315,000                           | \$5,427,000                           | \$ 418,000     | \$23,160,000 |
| Fixed asset additions   | \$ 189,000                             | \$ 415,000                            | \$ 8,000       | \$ 612,000   |

15

|                                     | For the Three Months Ended July 31, 2006 |                                       |       |              |
|-------------------------------------|--|---------------------------------------|-------|--------------|
|                                     | Nutraceutical<br>Products                | Telecom<br>Infrastructure<br>Services | Other | Consolidate  |
| Net sales                           | \$ 5,211,000                             | \$3,349,000                           | \$ -- | \$ 8,560,000 |
| Cost of sales                       | 3,940,000                                | 2,678,000                             | --    | 6,618,000    |
| Gross profit                        | 1,271,000                                | 671,000                               | --    | 1,942,000    |
| Selling, general and administrative |  |                                       |       |              |



Edgar Filing: ARGAN INC - Form 10QSB

|   |              |             |              |              |
|---|--------------|-------------|--------------|--------------|
| expenses  | 1,070,000    | 424,000     | 450,000      | 1,944,000    |
|   | -----        | -----       | -----        | -----        |
| Income (loss) from operations   | 201,000      | 247,000     | (450,000)    | (2,000)      |
| Interest expense and amortization of subordinated debt issuance costs | 81,000       | 10,000      | 125,000      | 216,000      |
| Other income, net   | --           | 1,000       | --           | 1,000        |
|   | -----        | -----       | -----        | -----        |
| Income (loss) before income taxes                                     | \$ 120,000   | \$ 238,000  | \$ (575,000) | (217,000)    |
|   | =====        | =====       | =====        | -----        |
| Income tax benefit  |              |             |              | 62,000       |
|   |              |             |              | -----        |
| Net loss  |              |             |              | \$ (155,000) |
|   |              |             |              | =====        |
| Depreciation and amortization   | \$ 139,000   | \$ 119,000  | \$ 141,000   | \$ 399,000   |
|   | =====        | =====       | =====        | =====        |
| Amortization of intangibles   | \$ 304,000   | \$ 25,000   | \$ --        | \$ 329,000   |
|   | =====        | =====       | =====        | =====        |
| Goodwill  | \$ 6,565,000 | \$ 940,000  | \$ --        | \$ 7,505,000 |
|   | =====        | =====       | =====        | =====        |
| Total assets  | \$17,315,000 | \$5,427,000 | \$ 418,000   | \$23,160,000 |
|   | =====        | =====       | =====        | =====        |
| Fixed asset additions   | \$ 93,000    | \$ 238,000  | \$ 8,000     | \$ 339,000   |
|   | =====        | =====       | =====        | =====        |

For the Six Months Ended July 31, 2005

|   | Nutraceutical<br>Products | Telecom<br>Infrastructure<br>Services | Other          | Consolidate    |
|---|---------------------------|---------------------------------------|----------------|----------------|
|   | -----                     | -----                                 | -----          | -----          |
| Net sales   | \$ 9,252,000              | \$4,756,000                           | \$ --          | \$14,008,000   |
| Cost of sales   | 6,989,000                 | 3,839,000                             | --             | 10,828,000     |
|   | -----                     | -----                                 | -----          | -----          |
| Gross profit  | 2,263,000                 | 917,000                               |                | 3,180,000      |
| Selling, general and administrative expenses                          | 2,254,000                 | 723,000                               | 849,000        | 3,826,000      |
|   | -----                     | -----                                 | -----          | -----          |
| (Loss) income from operations   | 9,000                     | 194,000                               | (849,000)      | (646,000)      |
| Interest expense and amortization of subordinated debt issuance costs | 132,000                   | 24,000                                | 3,000          | 159,000        |
| Other expense, net  | --                        | --                                    | 1,925,000      | 1,925,000      |
|   | -----                     | -----                                 | -----          | -----          |
| (Loss) income before income taxes                                     | \$ (123,000)              | \$ 170,000                            | \$ (2,777,000) | (2,730,000)    |
|   | =====                     | =====                                 | =====          | -----          |
| Income tax benefit  |                           |                                       |                | 322,000        |
|   |                           |                                       |                | -----          |
| Net loss  |                           |                                       |                | \$ (2,408,000) |
|   |                           |                                       |                | =====          |
| Depreciation and amortization   | \$ 166,000                | \$ 198,000                            | \$ 58,000      | \$ 422,000     |
|   | =====                     | =====                                 | =====          | =====          |
| Amortization of intangibles   | \$ 796,000                | \$ 52,000                             | \$ --          | \$ 848,000     |
|   | =====                     | =====                                 | =====          | =====          |
| Goodwill  | \$ 12,375,000             | \$ 940,000                            | \$ --          | \$13,315,000   |
|   | =====                     | =====                                 | =====          | =====          |
| Total Assets  | \$ 24,310,000             | \$5,306,000                           | \$ 875,000     | \$30,491,000   |
|   | =====                     | =====                                 | =====          | =====          |

|  | For the Three Months Ended July 31, 2005 |                                       |                |                |
|--|--|---------------------------------------|----------------|----------------|
|  | Nutraceutical<br>Products                | Telecom<br>Infrastructure<br>Services | Other          | Consolidate    |
| Net sales  | \$ 4,524,000                             | \$2,328,000                           | \$ --          | \$ 6,852,000   |
| Cost of sales  | 3,559,000                                | 1,932,000                             | --             | 5,491,000      |
| Gross profit   | 965,000                                  | 396,000                               | --             | 1,361,000      |
| Selling, general and administrative<br>expenses                          | 1,168,000                                | 369,000                               | 449,000        | 1,986,000      |
| (Loss) income from operations  | (203,000)                                | 27,000                                | (449,000)      | (625,000)      |
| Interest expense and amortization of<br>subordinated debt issuance costs | 74,000                                   | 13,000                                | 16,000         | 103,000        |
| Other expense, net   | --                                       | --                                    | 1,952,000      | 1,952,000      |
| (Loss) income before income taxes  | \$ (277,000)                             | \$ 14,000                             | \$ (2,417,000) | (2,680,000)    |
| Income tax benefit   |  |                                       |                | 294,000        |
| Net loss   |  |                                       |                | \$ (2,386,000) |
| Depreciation and amortization  | \$ 89,000                                | \$ 100,000                            | \$ 38,000      | \$ 227,000     |
| Amortization of intangibles  | \$ 397,000                               | \$ 27,000                             | \$ --          | \$ 424,000     |
| Goodwill   | \$12,375,000                             | \$ 940,000                            | \$ --          | \$13,315,000   |
| Total Assets   | \$24,310,000                             | \$5,306,000                           | \$ 875,000     | \$30,491,000   |

## NOTE 10 - CONTINGENCIES

On September 17, 2004, Western Filter Corporation (WFC) notified the Company that WFC believes that the Company breached certain representations and warranties under the stock purchase agreement dated October 31, 2003 by and between AI and WFC ("Stock Purchase Agreement"). WFC asserts damages in excess of the \$300,000 escrow which is being held by a third party in connection with the Stock Purchase Agreement.

On March 22, 2005, WFC filed a complaint in Los Angeles Superior Court alleging the Company and its executive officers, individually, committed breach of contract, intentional misrepresentation, concealment and non-disclosure, negligent misrepresentation and false promise. WFC seeks declaratory relief and compensatory and punitive damages in an amount to be proven at trial as well as the recovery of attorney's fees.

Although the Company has reviewed WFC's claim and believes that substantially all of the claims are without merit, at July 31, 2006, the Company has recorded an accrual related to this matter of \$360,000 for estimated payments and legal fees related to the claims of WFC that it considers to be probable and that can

## Edgar Filing: ARGAN INC - Form 10QSB

be reasonably estimated. It is possible however, that the ultimate resolution of WFC's claim could result in a material adverse effect on the Company's results of operations for a particular reporting period. The Company will vigorously contest WFC's claim.

In the normal course of business, the Company has pending claims and legal proceedings. It is the opinion of the Company's management, based on information available at this time, that none of the other current claims and proceedings will have a material effect on the Company's consolidated financial statements.

17

### NOTE 11 - LETTER OF INTENT

During July 2006, the Company entered into a letter of intent detailing its proposed merger with Supplement and Nutrition Technologies, Inc. (SNT). The consummation of this proposed acquisition is contingent upon the completion of the Company's due diligence, the signing of a definitive purchase and sale agreement, approval of both companies' board of directors and other conditions.

### NOTE 12 - SUBSEQUENT EVENT

During August 2006, the Company entered into a letter of intent detailing its proposed merger with Gemma Power Systems, LLC (Gemma). The consummation of this proposed acquisition is contingent upon the completion of the Company's due diligence, the signing of a definitive purchase and sale agreement, approval of both companies' board of directors and other conditions.

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

This Form 10-QSB contains certain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbor created thereby. These statements relate to future events or our future financial performance, including statements relating to our products, customers, suppliers, business prospects, financings, investments and effects of acquisitions. In some cases, forward looking statements can be identified by terminology such as "may," "will," "should," "expect," "anticipate," "intend," "plan," "believe," "estimate," "potential," or "continue," the negative of these terms or other comparable terminology. These statements involve a number of risks and uncertainties, including preliminary information; the effects of future acquisitions and/or investments; competitive factors; business and economic conditions generally; changes in government regulations and policies, our dependence upon third-party suppliers; continued acceptance of our products in the marketplace; technological changes; and other risks and uncertainties that could cause actual events or results to differ materially from any forward-looking statement.

### GENERAL

Argan, Inc. (the "Company," "we," "us," or "our") conduct our operations through our wholly owned subsidiaries, Vitarich Laboratories, Inc. ("VLI") that we acquired in August 2004 and Southern Maryland Cable, Inc. ("SMC") that we acquired in July 2003. Through VLI, we develop, manufacture and distribute premium nutritional products. Through SMC, we provide telecommunications infrastructure services including project management, construction and maintenance to the Federal Government, telecommunications and broadband service providers as well as electric utilities.

Private Offering of Common Stock

## Edgar Filing: ARGAN INC - Form 10QSB

On May 4, 2006, the Company completed a private offering of 760,000 shares of common stock at a price of \$2.50 per share for aggregate proceeds of \$1.9 million. These shares were registered with the SEC effective July 10, 2006. The Company used \$1.8 million of the proceeds to pay down an equal notional amount of the subordinated note due Kevin Thomas. The remainder of the proceeds were used for general corporate purposes.

One of the investors, MSRI SBIC, L.P., which acquired 240,000 shares in the offering, is controlled by Daniel Levinson, a director of the Company. In addition, James Quinn, a director of the Company acquired 40,000 shares for his own account.

18

### Subordination of Certain Debt

On January 31, 2005, the Company entered into a Debt Subordination Agreement ("Subordination Agreement") with Kevin J. Thomas ("Thomas"), Southern Maryland Cable, Inc., a wholly owned subsidiary of the Company ("SMC," and together with the Company, the "Debtor") and Bank of America, N.A. ("Lender") to reconstitute as subordinated debt certain additional cash consideration ("Additional Cash Consideration") that Debtor will owe to Thomas in connection with the Agreement and Plan of Merger dated August 31, 2004 as amended, by and among the Company, AGAX/VLI Acquisition Corporation, a subsidiary of the Company, VLI and Thomas ("Merger Agreement").

Pursuant to the Subordination Agreement, Debtor and Thomas have agreed to reconstitute the Additional Cash Consideration as subordinated debt and in furtherance thereof, the Company has agreed to execute and deliver to Thomas a Subordinated Promissory Note in an amount equal to the amount that would otherwise be due Thomas as Additional Cash Consideration under the Merger Agreement. Accordingly, under the Subordination Agreement, Debtor subordinated all of the Junior Debt (as such term is defined in the Subordination Agreement) to the full extent provided in the Subordination Agreement, and Thomas transferred and assigned to Lender all of his rights, title and interest in the Junior Debt and appointed Lender as his attorney-in-fact for the purposes provided in the Subordination Agreement for as long as any of the Superior Debt (as such term is defined in the Subordination Agreement) remains outstanding. Except as otherwise provided in the Subordination Agreement and until such time that the Superior Debt is satisfied in full, Debtor shall not, among other things, directly or indirectly, in any way, satisfy any part of the Junior Debt, nor shall Thomas, among other things, enforce any part of the Junior Debt or accept payment from Debtor or any other person for the Junior Debt or give any subordination in respect of the Junior Debt.

The subordinated debt due the former owner of VLI was originally due on August 1, 2006. On May 5, 2006, the Company entered into an agreement with the former owner of VLI to delay the timing of the payment on the subordinated debt to August 1, 2007. The Company also has the option to draw on the New Term Loan (as defined below) to pay the former owner of VLI if we are in compliance with our debt covenants with the Bank of America, N.A. The remaining principal and interest due on this note was paid on August 31, 2006, with a draw from the New Term Loan (as defined below).

### Amendment of Financing Arrangements

In May 2006, the Company agreed to amend the existing financing arrangements with the Bank of America, N.A. (Bank). Under this arrangement, the Company has a

## Edgar Filing: ARGAN INC - Form 10QSB

revolving line of credit of \$4.25 million in maximum availability and a term loan with an original balance of \$1.2 million. The May 2006 amendment extended the expiration of the revolving line of credit to May 31, 2007. Under the amended financing arrangements, amounts outstanding under the revolving line of credit and the three-year note bear interest at LIBOR plus 3.25% and 3.45% respectively. Availability on a monthly basis under the revolving line is determined by reference to accounts receivable and inventory on hand which meet certain Bank criteria (Borrowing Base). The aforementioned three-year note was paid in full on July 31, 2006. At July 31, 2006 and January 31, 2006, the Company also had \$1,343,000 and \$1,243,000, respectively, outstanding under the revolving line of credit and an effective interest rate of 8.7% and 7.74%, respectively, with \$2.9 million of additional availability under its Borrowing Base.

The amended financing arrangements provides for a new \$1.5 million term loan facility (New Term Loan). The proceeds of the New Term Loan are designated to refinance the subordinated note with Kevin Thomas that at July 31, 2006 and January 31, 2006, had a current outstanding balance of \$1,492,000 and \$3,292,000, respectively, which is due on August 1, 2007. Advances under the New Term Loan are subject to the Company being in compliance with its debt covenants with the Bank. The New Term Loan will be repaid in thirty-six equal monthly principal payments and bears interest at LIBOR plus 3.25%. On August 31, 2006, the Company borrowed \$1.5 million under the New Term Loan and paid the remaining principal and interest due on the subordinated note with Thomas. As a result of this draw, the Company's Borrowing Base will be reduced by \$750,000 for maximum availability under the revolving line of credit.

19

The amended financing arrangements provides for the measurement of certain financial covenants including requiring the ratio of debt to pro forma earnings before interest, taxes, depreciation and amortization (EBITDA) not to exceed 2.5 to 1 and requiring pro forma fixed charge coverage ratio not less than 1.25 to 1. The amended financings also require that the Company meet minimum EBITDA covenants equal to or exceeding (on a trailing twelve months) \$1.2 million for July 31, 2006, \$1.3 million for October 31, 2006 and \$1.8 million for January 31, 2007 and for each successive quarter end thereafter. The Bank's consent continues to be required for acquisitions and divestitures. The Company continues to pledge the majority of the Company's assets to secure the financing arrangements.

The amended financing arrangement contains a subjective acceleration clause which allows the Bank to declare amounts outstanding under the financing arrangement due and payable if certain material adverse changes occur. We believe that we will continue to comply with our financial covenants under our financing arrangement. If our performance does not result in compliance with any of our financial covenants, or if the Bank seeks to exercise its rights under the subjective acceleration clause referred to above, we would seek to modify our financing arrangement, but there can be no assurance that the Bank would not exercise their rights and remedies under our financing arrangement including accelerating payment of all outstanding senior and subordinated debt due and payable.

### Holding Company Structure

We intend to make additional acquisitions and/or investments. We intend to have more than one industrial focus and to identify those companies that are in industries with significant potential to grow profitably both internally and through acquisitions. We expect that companies acquired in each of these

## Edgar Filing: ARGAN INC - Form 10QSB

industrial groups will be held in separate subsidiaries that will be operated in a manner that best provides cashflow and value for the Company.

We are a holding company with no operations other than our investments in VLI and SMC. At July 31, 2006, there were no restrictions with respect to dividends or other payments from VLI and SMC to the Company.

### Nutritional Products

We are dedicated to the research, development, manufacture and distribution of premium nutritional supplements, whole-food dietary supplements and personal care products. Several of these products have garnered honors including the National Nutritional Foods Association's prestigious Peoples Choice Awards for best products of the year in its respective category.

We provide nutrient-dense, super-food concentrates, vitamins and supplements. Our customers include health food store chains, mass merchandisers, network marketing companies, pharmacies and major retailers.

We intend to enhance our position in the fast growing global nutrition industry through our innovative product development and research. We believe that we will be able to expand our distribution channels by providing continuous quality assurance and by focusing on timely delivery of superior nutraceutical products.

We are focused on efficiently utilizing the strong cash flow potential from manufacturing nutritional products. To ensure that working capital is effectively allocated, we closely monitor our inventory turns as well as the number of days sales that we have in our accounts receivable.

20

### Telecom Infrastructure Services

We currently provide inside plant, premise wiring services to the Federal Government and have plans to expand that work to commercial customers who regularly need upgrades in their premise wiring systems to accommodate improvements in security, telecommunications and network capabilities.

We continue to participate in the expansion of the telecommunications industry by working with various telecommunications providers. We are actively pursuing contracts with a wide variety of telecommunications providers. We provide maintenance and upgrade services for their outside plant systems that increase the capacity of existing infrastructure. We also provide outside plant services to the power industry by providing maintenance and upgrade services to utilities.

We intend to emphasize our high quality reputation, outstanding customer base and highly motivated work force in competing for larger and more diverse contracts. We believe that our high quality and well maintained fleet of vehicles and construction machinery and equipment is essential to meet customers' needs for high quality and on-time service. We are committed to invest in our repair and maintenance capabilities to maintain the quality and life of our equipment. Additionally, we invest annually in new vehicles and equipment.

### Letters of Intent

During July 2006, the Company entered into a letter of intent detailing its proposed merger with Supplement and Nutrition Technologies, Inc. (SNT). The

## Edgar Filing: ARGAN INC - Form 10QSB

consummation of this proposed acquisition is contingent upon the completion of the Company's due diligence, the signing of a definitive purchase and sale agreement, approval of both companies' board of directors and other conditions.

During August 2006, the Company entered into a letter of intent detailing its proposed merger with Gemma Power Systems, LLC (Gemma). The consummation of this proposed acquisition is contingent upon the completion of the Company's due diligence, the signing of a definitive purchase and sale agreement, approval of both companies' board of directors and other conditions.

### CRITICAL ACCOUNTING POLICIES

Management is required to make judgments, assumptions and estimates that affect the amounts reported when we prepare financial statements and related disclosures in conformity with generally accepted accounting principles. Note 2 contained in the Company's consolidated financial statements for the year ended January 31, 2006 included in the Company's Annual Report contained in Form 10-KSB, as filed with the Securities and Exchange Commission describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. Estimates are used for, but not limited to our accounting for revenue recognition, allowance for doubtful accounts, inventory valuation, long-lived assets and deferred income taxes. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of our consolidated financial statements. If future conditions and results are different than our assumptions and estimates, materially different amounts could be reported.

#### Revenue Recognition

21

#### Vitarich Laboratories, Inc.

We manufacture products for our customers based on their orders. We typically ship the orders immediately after production keeping relatively little on-hand as finished goods inventory. We recognize customer sales at the time title and the risks and rewards of ownership passes to our customer which is generally when orders are shipped. Sales are recognized on a net basis which reflect reductions for certain product returns and discounts. Cost of goods sold and finished goods inventory sold include materials and direct labor as well as other direct costs combine with allocations of indirect operational costs.

#### Southern Maryland Cable, Inc.

We generate revenue under various arrangements, including contracts under which revenue is based on a fixed price basis and on a time and materials basis. Revenues from time and materials contracts are recognized when the related service is provided to the customer. Revenues from fixed price contracts, including a portion of estimated profit, are recognized as services are provided, based on costs incurred and estimated total contract costs using the percentage of completion method.

The timing of billing to customers varies based on individual contracts and often differs from the period of revenue recognition. Estimated earnings in excess of billings and billings in excess of estimated earnings totaled \$581,000 and \$7,000, respectively, at July 31, 2006.

Contract costs are recorded when incurred and include direct labor and other

## Edgar Filing: ARGAN INC - Form 10QSB

direct costs combined with allocations of operational indirect costs. Management periodically reviews the costs incurred and revenue recognized from contracts and adjusts recognized revenue to reflect current expectations. Provisions for estimated losses on incomplete contracts are provided in full in the period in which such losses become known.

### Inventories

Inventories are stated at the lower of cost or market (net realizable value). Cost is determined on the first-in first-out (FIFO) method. Appropriate consideration is given to obsolescence, excessive inventory levels, product deterioration and other factors in evaluating net realizable value.

### Impairment of Long-Lived Assets, Including Definite Lived Intangible Assets

Long-lived assets, consisting primarily of property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be assessed pursuant to SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We determine whether any impairment exists by comparing the carrying value of these long-lived assets to the undiscounted future cash flows expected to result from the use of these assets. In the event we determine that an impairment exists, a loss would be recognized based on the amount by which the carrying value exceeds the fair value of the assets, which is generally determined by using quoted market prices or valuation techniques such as the discounted present value of expected future cash flows, appraisals, or other pricing models as appropriate.

### Goodwill and Other Indefinite Lived Intangible Assets

In connection with the acquisitions of VLI and SMC, the Company has substantial goodwill and intangible assets including contractual customer relationships, proprietary formulas, non-compete agreements and trade names. In accordance with SFAS 142 "Goodwill and Other Intangible Assets," the Company reviews for impairment, at least annually, goodwill and intangible assets deemed to have an indefinite life.

22

Goodwill impairment is determined using a two-step process. The first step of the goodwill impairment test is to identify a potential impairment by comparing the fair value of a reporting unit with its carrying amount, including goodwill. The estimates of fair value of a reporting unit, generally a Company's operating segment, is determined using various valuation techniques, with the principal techniques being a discounted cash flow analysis and market multiple valuation. A discounted cash flow analysis requires making various judgmental assumptions, including assumptions about future cash flows, growth rates and discount rates. Developing assumptions for the Company's entrepreneurial business requires significant judgment and to a great extent relies on the Company's ability to successfully determine trends with respect to customers, industry and regulatory environment. The assumptions, including assumptions about future flows and growth rates, are based on the Company's budget and business plans as well as industry trends with respect to customers and other manufacturers' and distributors' sales and margins. The Company reviews trends for publicly traded companies which either compete with the Company to provide services or the types of products the Company produces or are users of the types of services and products provided by the Company. Changes in economic and operating conditions impacting these assumptions could result in goodwill impairment in future periods. Discount rate assumptions are based on the Company's subjective assessment of the risk inherent in the respective reporting units. Risks which



## Edgar Filing: ARGAN INC - Form 10QSB

the Company faces in its business include the public's perception of our integrity and the safety and quality of our products and services. In addition, in the industries that we operate we are subject to rapidly changing consumer demands and preferences. The Company also operates in competitive industries. We are not assured that customers or potential customers will regard our products and services as sufficiently distinguishable from our competitors' product and service offerings. If after taking into consideration industry and Company trends, the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not deemed impaired and the second step of the impairment test is not performed. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. Accordingly, the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit.

The Company will test for impairment of Goodwill and other intangible assets more frequently if events or changes in circumstances indicate that the asset might be impaired.

### Contractual Customer Relationships

Southern Maryland Cable, Inc. - The fair value of the Contractual Customer Relationships (CCR's) was determined at the time of the acquisition of SMC by discounting the cash flows expected from SMC's continued relationships with three customers - General Dynamics Corp. (GD), Verizon Communications (VZ) and Southern Maryland Electric Cooperative (SMECO). Expected cash flows were based on historical levels, current and anticipated projects and general economic conditions. In some cases, the estimates of future cash flows reflect periods beyond those of the current contracts in place. While SMC's relationship with GD is relatively recent, SMC has performed work for VZ and SMECO for approximately twenty years and ten years, respectively. The long-term relationship with VZ and SMECO affected the discount rate used to discount cost of capital and SMC's asset mix. We are amortizing the CCR's over a seven year weighted average life given the long standing relationships SMC has with Verizon and SMECO.

23

Vitarich Laboratories, Inc. - The fair value of the Contractual Customer Relationships at VLI (VCCR's) was determined at the time of the acquisition of VLI by identifying long established customer relationships in which VLI has a pattern of recurring purchase and sales orders. The Company estimated expected cash flows attributable to these existing customer relationships factoring in market place assumptions regarding future contract renewals, customer attrition rates and forecasted expenses to maintain the installed customer base. These cash flows were then discounted based on a rate that reflects the perceived risk of the VCCR's, the Company's estimated weighted average cost of capital and VLI's asset mix. VLI has had a relationship of five years or more with most of its currently significant customers. We are amortizing VCCR's over a five year life based on our expectations of continued cash flows from these relationships and our history of maintaining relationships.

Trade Name

## Edgar Filing: ARGAN INC - Form 10QSB

The fair value of the SMC trade name was estimated using a relief-from-royalty methodology. We determined that the useful life of the trade name was indefinite since it is expected to contribute directly to future cash flows in perpetuity. The Company has also considered the effects of demand and competition including its customer base. While SMC is not a nationally recognized trade name, it is a regionally recognized name in the Mid-Atlantic region, SMC's primary region of operations.

We are using the relief-from-royalty method described above to test the trade name for impairment annually on November 1 and on an interim basis if events or changes in circumstances between annual tests indicate the trade name might be impaired.

### Proprietary Formulas

The Fair Value of the Proprietary Formulas (PFs) was determined at the time of the acquisition of VLI by discounting the cash flows expected from developed formulations based on relative technology contribution and estimates regarding product lifecycle and development costs and time. The expected cash flows were discounted based on a rate that reflects the perceived risk of the PFs, the estimated weighted average cost of capital and VLI's asset mix. We are amortizing the PFs over a three year life based on the estimated contributory life of the proprietary formulations utilizing estimated historical product lifecycles and changes in technology.

### Non-Compete Agreement

The fair value of the Non-Compete Agreement (NCA) was determined at the time of acquisition of VLI by discounting the estimated reduction in the cash flows expected if one key employee, the former sole shareholder of VLI, were to leave. The key employee signed a non-compete clause prohibiting the employee from competing directly or indirectly for five years. The estimated reduced cash flows were discounted based on a rate that reflects the perceived risk of the NCA, the estimated weighted average cost of capital and VLI's asset mix. We are amortizing the NCA over five years, the length of the non-compete agreement.

### Derivative Financial Instruments

The Company accounts for derivative financial instruments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities" and Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock." The derivative financial instruments are carried at fair value with changes in fair value recorded as other expense, net. The determination of fair value for our derivative financial instruments is subject to the volatility of our stock price as well as certain underlying assumptions which include the probability of raising additional capital.

### Deferred Tax Assets and Liabilities

We account for income taxes under the asset and liability method. The approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. Developing our provision for income taxes requires significant judgment and expertise in Federal and state income

## Edgar Filing: ARGAN INC - Form 10QSB

tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, if necessary, any valuation allowances that may be required for deferred tax assets.

### WESTERN FILTER CORPORATION LITIGATION

On September 17, 2004, Western Filter Corporation ("WFC") notified the Company that WFC believes that the Company breached certain representations and warranties under the stock purchase agreement dated October 31, 2003 by and between Argan, Inc. and WFC ("Stock Purchase Agreement"). WFC asserts damages in excess of the \$300,000 escrow which is being held by a third party in connection with the Stock Purchase Agreement.

On March 22, 2005, WFC filed a complaint in Los Angeles Superior Court alleging the Company and its executive officers, individually, committed breach of contract, intentional misrepresentation, concealment and non-disclosure, negligent misrepresentation and false promise. WFC seeks declaratory relief and compensatory and punitive damages in an amount to be proven at trial as well as the recovery of attorneys' fees.

Although the Company has reviewed WFC's claim and believes that substantially all of the claims are without merit, at July 31, 2006, the Company had an accrual related to this matter of \$360,000 for estimated payments and legal fees related to the claims of WFC that it considers to be probable and that can be reasonably estimated. It is possible, however, that the ultimate resolution of WFC's claim could result in a material adverse effect on the Company's results of operations for a particular reporting period. The Company will vigorously contest WFC's claim.

25

### CONSOLIDATED RESULTS OF OPERATIONS

For the three months ended July 31:

|   | 2006        | 2005         | Increase<br>(Decrease) | Percent<br>Change |
|---|-------------|--------------|------------------------|-------------------|
|   | -----       | -----        | -----                  | -----             |
| Net sales   |             |              |                        |                   |
| Nutraceutical products  | \$5,211,000 | \$ 4,524,000 | \$ 687,000             | 15.0%             |
| Telecom infrastructure services                                       | 3,349,000   | 2,328,000    | 1,021,000              | 44.0              |
|   | -----       | -----        | -----                  | -----             |
| Net Sales   | 8,560,000   | 6,852,000    | 1,708,000              | 25.0              |
| Cost of sales   |             |              |                        |                   |
| Nutraceutical products  | 3,940,000   | 3,559,000    | 381,000                | 11.0              |
| Telecom infrastructure services                                       | 2,678,000   | 1,932,000    | 746,000                | 39.0              |
|   | -----       | -----        | -----                  | -----             |
| Gross profit  | 1,942,000   | 1,361,000    | 581,000                | 43.0              |
| Selling, general and administrative expenses                          | 1,944,000   | 1,986,000    | (42,000)               | (2.0)             |
|   | -----       | -----        | -----                  | -----             |
| Income (loss) from operations   | (2,000)     | (625,000)    | 623,000                | (100.0)           |
| Interest expense and amortization of subordinated debt issuance costs | 216,000     | 103,000      | 113,000                | 110.0             |
| Other (income ) expense, net  | (1,000)     | 1,952,000    | (1,953,000)            | (100.0)           |
|   | -----       | -----        | -----                  | -----             |

## Edgar Filing: ARGAN INC - Form 10QSB

|                                      |              |                |             |        |
|--------------------------------------|--------------|----------------|-------------|--------|
| Income (loss) from operations before |              |                |             |        |
| income taxes                         | (217,000)    | (2,680,000)    | 2,463,000   | (92.0) |
| Income tax benefit                   | 62,000       | 294,000        | (232,000)   | (79.0) |
|                                      | -----        | -----          | -----       | -----  |
| Net loss                             | \$ (155,000) | \$ (2,386,000) | \$2,231,000 | (94.0) |
|                                      | =====        | =====          | =====       | =====  |

### Net sales

Net sales of nutraceutical products increased by \$687,000 or 15% for the three months ended July 31, 2006 compared to the three months ended July 31, 2005, primarily due to increased sales to one of our largest customers, Rob Reiss Companies (RRC) as well as to six new customers.

Net sales of telecommunications infrastructure services increased by \$1,021,000 or 44% for the three months ended July 31, 2006 compared to the three months ended July 31, 2005, primarily due to increased sales to VZ, SMECO and Electronic Data Systems Corp. (EDS) which offset the decline in business with GD whose contract with SMC was completed last year.

### Cost of sales

For the three months ended July 31, 2006, cost of sales for nutraceutical products was 76% of net sales for nutraceutical products. For the three months ended July 31, 2005, cost of sales was 79% of net sales for nutraceutical products. VLI experienced a lower percentage of cost of sales during the three months ended July 31, 2006 due to VLI passing along increased costs of non-nutritional materials whose cost was affected by the rise in oil prices. In addition, VLI has been reviewing its vendor relationships to ensure quality materials are obtained at competitive prices.

For the three months ended July 31, 2006, cost of sales for telecommunications infrastructure services was 80% of net sales of telecommunications infrastructure services. For the three months ended July 31, 2005, cost of sales was 83% of net sales of telecommunications infrastructure services. SMC experienced improved percentage margin performance due primarily to more effective utilization of construction personnel and equipment assigned to VZ and EDS as the net sales to both customers increased.

26

### Selling, general and administrative expenses

Consolidated selling, general and administrative expenses were \$1,944,000 or 23% of consolidated net sales for the three months ended July 31, 2006 compared to \$1,973,000 or 29% of consolidated net sales for the three months ended July 31, 2005. VLI had lower amortization of purchased intangibles of \$93,000 due to lower basis in such assets in current fiscal year.

### Interest expense and amortization of subordinated debt issuance costs

Consolidated interest expense and amortization of subordinated debt issuance costs increased by \$113,000 or 110% for the three months ended July 31, 2006 compared to the three months ended July 31, 2005, due primarily to the amortization of issuance costs for the subordinated debt of \$128,000 for the three months ended July 31, 2006. The subordinated note was issued on June 30, 2005 resulting in one month of amortization for the three months ended July 31, 2005.

## Edgar Filing: ARGAN INC - Form 10QSB

Other (income) expense, net

Other (income) expense, net changed from \$1,952,000 in expense for the three months ended July 31, 2005 to income of \$1,000 for the three months ended July 31, 2006, primarily due to the fair value loss of the liability for derivative financial instrument of \$1,952,000 realized during the three months ended July 31, 2005.

Income tax benefit

The Company's consolidated effective income tax benefit rate was 29% for the three months ended July 31, 2006 compared to an 11% effective income tax benefit rate for the three months ended July 31, 2005.

During the three months ended July 31, 2006, the Company's effective income tax rate benefit was increased by the impact of the amortization of issuance cost for subordinated debt which is treated as a permanent difference for income tax reporting purposes. This permanent difference reduced the effective income tax benefit rate from 38%.

For the three months ended July 31, 2005, the Company's effective income tax benefit rate was decreased by the impact of the fair value adjustment for liability for derivative financial instrument which is a permanent difference for income tax reporting purposes. This permanent difference reduced the effective income tax benefit rate from 38%.

For the six months ended July 31:

|   | 2006         | 2005           | Increase<br>(Decrease) | Percent<br>Change |
|---|--------------|----------------|------------------------|-------------------|
|   | -----        | -----          | -----                  | -----             |
| Net sales   |              |                |                        |                   |
| Nutraceutical products  | \$11,040,000 | \$ 9,252,000   | \$ 1,788,000           | 19.0%             |
| Telecom infrastructure services                                       | 6,482,000    | 4,756,000      | 1,726,000              | 36.0              |
|   | -----        | -----          | -----                  |                   |
| Net Sales   | 17,522,000   | 14,008,000     | 3,514,000              | 25.0              |
| Cost of sales   |              |                |                        |                   |
| Nutraceutical products  | 8,326,000    | 6,989,000      | 1,337,000              | 19.0              |
| Telecom infrastructure services                                       | 5,001,000    | 3,839,000      | 1,162,000              | 30.0              |
|   | -----        | -----          | -----                  |                   |
| Gross profit  | 4,195,000    | 3,180,000      | 1,015,000              | 32.0              |
| Selling, general and administrative expenses                          | 3,920,000    | 3,826,000      | 94,000                 | 2.0               |
|   | -----        | -----          | -----                  |                   |
| Income (loss) from operations   | 275,000      | (646,000)      | 921,000                | (143.0)           |
| Interest expense and amortization of subordinated debt issuance costs | 477,000      | 159,000        | 318,000                | 200.0             |
| Other (income) expense, net   | (3,000)      | 1,925,000      | (1,928,000)            | (100.0)           |
|   | -----        | -----          | -----                  |                   |
| Loss from operations before income taxes                              | (199,000)    | (2,730,000)    | 2,531,000              | (93.0)            |
| Income tax benefit  | 26,000       | 322,000        | (296,000)              | (92.0)            |
|   | -----        | -----          | -----                  |                   |
| Net loss  | \$ (173,000) | \$ (2,408,000) | \$ 2,235,000           | (93.0)            |
|   | =====        | =====          | =====                  |                   |

## Net sales

Net sales of nutraceutical products increased by \$1,788,000 or 19% for the six months ended July 31, 2006 compared to the six months ended July 31, 2005, primarily due to increased sales to one of our largest customers Rob Reiss Companies (RRC) as well as to six new customers.

Net sales of telecommunications infrastructure services increased by \$1,726,000 or 36% for the six months ended July 31, 2006 compared to the six months ended July 31, 2005, primarily due to increased sales to VZ, SMECO and Electronic Data Systems Corp. (EDS) which offset the decline in business with GD whose contract with SMC was completed last year.

## Cost of sales

For the six months ended July 31, 2006, cost of sales for nutraceutical products was 75% of net sales for nutraceutical products. For the six months ended July 31, 2005, cost of sales was 76% net sales for nutraceutical products. VLI experienced a lower percentage of cost of sales during the six months ended July 31, 2006 due to VLI passing along to customers increased costs of non-nutritional materials whose cost was affected by the rise in oil prices. In addition, VLI has been reviewing its vendor relationships to ensure quality and competitive prices.

For the six months ended July 31, 2006, cost of sales for telecommunications infrastructure services were 77% of net sales of telecommunications infrastructure services. For the six months ended July 31, 2005, cost of sales was 81% of net sales of telecommunications infrastructure services. SMC experienced improved percentage margin performance due primarily to more effective utilization of construction personnel and equipment assigned to VZ and EDS as the net sales to both customers increased.

## Selling, general and administrative expenses

Consolidated selling, general and administrative expenses were \$3,920,000 or 22% of consolidated net sales for the six months ended July 31, 2006 compared to \$3,826,000 or 27% of consolidated net sales for the six months ended July 31, 2005. SMC increased its selling, general and administrative expenses due to the hiring of additional sales support personnel. In addition, SMC has incurred expense for bonuses as a result of improved financial performance for the six months ended July 31, 2006. Corporate expenses increased due to higher professional accounting service fees.

## Interest expense and amortization of subordinated debt issuance costs

Consolidated interest expense and amortization of subordinated debt issuance costs increased by \$318,000 or 200% for the six months ended July 31, 2006 compared to the six months ended July 31, 2005, due primarily to increased interest expense for subordinated debt of \$137,000 and amortization of issuance cost for the subordinated debt of \$257,000 for the six months ended July 31, 2006. The subordinated note was issued on June 30, 2005 resulting in one month of amortization for the six months ended July 31, 2005.

## Other (income) expense, net

## Edgar Filing: ARGAN INC - Form 10QSB

Other (income) expense, net changed from \$1,925,000 in expense for the six months ended July 31, 2005 to income of \$3,000 for the six months ended July 31, 2006, primarily due to the fair value loss of the liability for derivative financial instrument of \$1,929,000 realized during the six months ended July 31, 2005.

### Income tax benefit

The Company's consolidated effective income tax benefit rate was 13% for the six months ended July 31, 2006 compared to a 12% effective income tax benefit rate for the six months ended July 31, 2005.

During the six months ended July 31, 2006, the Company's effective income tax benefit rate was increased by the impact of the amortization of issuance cost for subordinated debt which is treated as a permanent difference for income tax reporting purposes. This permanent difference reduced the effective income tax benefit rate from 38%.

For the six months ended July 31, 2005, the Company's effective income tax benefit rate was increased by the impact of the fair value adjustment for liability for derivative financial instruments which is a permanent difference for income tax reporting purposes. This permanent difference reduced the effective income tax benefit rate from 38%.

### LIQUIDITY AND CAPITAL RESOURCES

#### Cash Position and Indebtedness

We had \$2.0 million in working capital at July 31, 2006, including \$161,000 of cash and cash equivalents. In addition we had \$2.9 million available under credit facilities.

Working capital increased by \$485,000 to \$2.0 million at July 31, 2006 from \$1.5 million at January 31, 2006. Components of the Company's cash flow provided by operations during the six months ended July 31, 2006 contributed to the increase in working capital. Accounts receivable increased by \$537,000 and prepaid expenses and other current assets increased by \$337,000 and due to affiliates decreased by \$108,000, which was offset, in part by a decrease in inventories of \$543,000. The Company had a loss before taxes of \$199,000 for the six months ended July 31, 2006. The Company's non-cash expenses included in the determination of income before taxes included \$660,000 for amortization of purchase intangibles and \$775,000 for depreciation and amortization.

#### Cash Flows

Net cash provided by operations for the six months ended July 31, 2006 was \$953,000 compared with \$754,000 of cash provided by operations for the six months ended July 31, 2005 due to the improved financial performance of both SMC and VLI. For the six months ended July 31, 2006, SMC had income from operations of \$643,000 compared to income from operations of \$194,000 for the six months ended July 31, 2005. Net sales from VZ increased by \$1.3 million due to SMC reestablishing a contractual relationship with VZ which had previously been discontinued. In July 2004, SMC lost a significantly profitable contract with VZ. In September 2005, SMC commenced work on an underground telecommunications infrastructure services contract with VZ which had been previously awarded to a third party which did not perform to VZ's satisfaction. In addition, SMC experienced strong revenue growth from SMECO and EDS. During the six months ended July 31, 2006, VLI had income from operations of \$557,000 compared to income from operations of \$9,000 for the six months ended July 31, 2005. VLI experienced strong revenue growth from one of its most significant customers,

## Edgar Filing: ARGAN INC - Form 10QSB

RRC as well as from six new customers.

29

During the six months ended July 31, 2006, accounts receivable used cash of \$537,000. Increases in revenue at both SMC and VLI resulted in the substantial increase in accounts receivable which was offset by inventories, net which provided cash flows of \$543,000. VLI exercised tighter controls over inventory levels as it experienced strong revenue growth.

During the six months ended July 31, 2006, net cash used for investing activities was \$608,000 compared to net cash used for investing activities of \$1,063,000 for the six months ended July 31, 2005. SMC paid for new directional boring equipment and trucks to respond to opportunities for additional customer work.

For the six months ended July 31, 2006, net cash used by financing activities was \$189,000 compared to cash provided by financing activities of \$266,000 for the six months ended July 31, 2005. The change from net cash provided by financing activities during the six months ended July 31, 2005 to net cash used during the six months ended July 31, 2006 is due to payments made on the line of credit, the term loan, and the subordinated note with Kevin Thomas, offset by net proceeds from the sale of stock. During the six months ended July 31, 2005, the Bank of America, N.A. released \$304,000 in previously escrowed funds in accordance with the amended financing arrangements of April 2005 which offset the net pay down of the Company's line of credit and long term debt.

In May 2006, the Company agreed to amend the existing financing arrangements with the Bank of America, N.A. (Bank). Under this arrangement, the Company has a revolving line of credit of \$4.25 million in maximum availability and a term loan with an original balance of \$1.2 million. The May 2006 amendment extended the expiration of the revolving line of debt to May 31, 2007. Under the amended financing arrangements, amounts outstanding under the revolving line of credit and the three-year note bear interest at LIBOR plus 3.25% and 3.45%, respectively. Availability on a monthly basis under the revolving line is determined by reference to accounts receivable and inventory on hand which meet certain Bank criteria (Borrowing Base). The aforementioned three-year note was paid in full on July 31, 2006. At July 31, 2006 and January 31, 2006, the Company had \$1,343,000 and \$1,243,000, respectively, outstanding under the revolving line of credit and an effective interest rate of 8.7% and 7.74%, respectively, with \$2.9 million of additional availability under its Borrowing Base.

The amended financing arrangement provides for a new \$1.5 million term loan facility (New Term Loan). The proceeds of the New Term Loan are designated to refinance the subordinated note with Kevin Thomas that had at July 31, 2006 and January 31, 2006 an outstanding balance of \$1,492,000 and \$3,292,000, respectively, which is due on August 1, 2007. Advances under the New Term Loan are subject to the Company being in compliance with its debt covenants with the Bank. The New Term Loan will be repaid in thirty-six equal monthly principal payments and bear interest at LIBOR plus 3.25%. On August 31, 2006, the Company borrowed \$1.5 million under the New Term Loan and paid the remaining principal and interest due on the subordinated note with Thomas. As a result of this draw, the Company's Borrowing Base will be reduced by \$750,000 for maximum availability under the revolving line of credit.

The amended financing arrangements provides for the measurement of certain financial covenants including requiring the ratio of debt to pro forma earnings before interest, taxes, depreciation and amortization (EBITDA) not to exceed 2.5



## Edgar Filing: ARGAN INC - Form 10QSB

to 1 and requiring pro forma fixed charge coverage ratio not less than 1.25 to 1. The amended financing arrangements also provide a requirement that the Company meet minimum EBITDA covenants equal to or exceeding (on a trailing twelve months) \$1.2 million for July 31, 2006, \$1.3 million for October 31, 2006 and \$1.8 million for January 31, 2007 and for each successive quarter end thereafter. Bank consent continues to be required for acquisitions and divestitures. The Company continues to pledge the majority of the Company's assets to secure the financing arrangements.

30

The amended financing arrangement contains a subjective acceleration clause which allows the Bank to declare amounts outstanding under the financing arrangement due and payable if certain material adverse changes occur. We believe that we will continue to comply with our financial covenants under our financing arrangement. If our performance does not result in compliance with any of our financial covenants, or if the Bank seeks to exercise its rights under the subjective acceleration clause referred to above, we would seek to modify our financing arrangement, but there can be no assurance that the Bank would not exercise their rights and remedies under our financing arrangement including accelerating payment of all outstanding senior and subordinated debt due and payable.

At July 31, 2006, the Company was in compliance with the covenants of its amended financing arrangements.

Management believes that cash generated from the Company's operations combined with capital resources available under its renewed line of credit is adequate to meet the Company's future operating cash needs. Any future acquisitions, other significant unplanned costs or cash requirements may require the Company to raise additional funds through the issuance of debt and equity securities. There can be no assurance that such financing will be available on terms acceptable to the Company, or at all. If additional funds are raised by issuing equity securities, significant dilution to the existing stockholders may result.

### Customers

During the six months ended July 31, 2006, we provided nutritional and whole-food supplements as well as personal care products to customers in the global nutrition industry and services to telecommunications and utilities customers as well as to the Federal Government, through a contract with Electronic Data Systems Corp. (EDS). Certain of our more significant customer relationships are with TriVita, Inc. (TVC), Rob Reiss Companies (RRC), Verizon Communications, Inc. (VZ), Southern Maryland Electrical Cooperative (SMECO), EDS, CyberWize.com, Inc. (C), and Orange Peel Enterprises, Inc. (OPE). TVC, RRC, C and OPE are VLI customers. SMC's significant customers are VZ, SMECO and EDS. TVC, RRC, C and OPE accounted for approximately 17%, 15%, 7% and 4% of consolidated net sales during the six months ended July 31, 2006. VZ, SMECO and EDS accounted for approximately 10%, 11% and 9% of consolidated net sales during the six months ended July 31, 2006. Combined TVC, RRC, VZ, SMECO, EDS, C and OPE accounted for approximately 75% of consolidated net sales during the six months ended July 31, 2006.

### Seasonality

The Company's telecom infrastructure services operations are expected to have seasonally weaker results in the first and fourth quarters of the year, and may produce stronger results in the second and third quarters. This seasonality is primarily due to the effect of winter weather on outside plant activities as

## Edgar Filing: ARGAN INC - Form 10QSB

well as reduced daylight hours and customer budgetary constraints. Certain customers tend to complete budgeted capital expenditures before the end of the year, and postpone additional expenditures until the subsequent fiscal period.

### IMPACT OF CHANGES IN ACCOUNTING STANDARDS

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 ("FIN 48"), which clarifies the accounting for uncertainty in income tax positions. FIN 48 requires that the Company recognize in the consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. The provisions of FIN 48 will be effective for the Company, as of the beginning of the Company's fiscal year ending January 31, 2008, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on the consolidated financial statements.

31

### ITEM 3. CONTROLS AND PROCEDURES

#### Disclosure Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15 of the Securities Exchange Act of 1934). Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that the Company's current disclosure controls and procedures are effective in timely alerting them of material information relating to the Company that is required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934.

#### Changes in Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) under the Securities Exchange Act of 1934 and for of the effectiveness of internal control over financial reporting.

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended July 31, 2006 that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

### PART 11 OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

(See Note 10 of the financial statements)

#### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On May 4, 2006, the Company completed a private offering of 760,000 shares of

## Edgar Filing: ARGAN INC - Form 10QSB

common stock at a price of \$2.50 per share for aggregate proceeds of \$1.9 million. These shares were registered with the SEC effective July 10, 2006. The Company used \$1.8 million of the proceeds to pay down an equal notional amount of the subordinated note due Kevin Thomas. The remainder of the proceeds were used for general corporate purposes.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

### ITEM 5. OTHER INFORMATION

None.

32

### ITEM 6. EXHIBITS

| Exhibit No.<br>----- | Title<br>-----   |
|----------------------|--|
| Exhibit: 31.1        | Certification of Chief Executive Officer, pursuant to Rule 13a-14(c) under the Securities Exchange Act of 1934 |
| Exhibit: 31.2        | Certification of Chief Financial Officer, pursuant to Rule 13a-14(c) under the Securities Exchange Act of 1934 |
| Exhibit: 32.1        | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350                                   |
| Exhibit: 32.2        | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350                                   |

33

### SIGNATURES

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

ARGAN, INC.

September 11, 2006

By: /s/ Rainer Bosselmann

-----  
Rainer Bosselmann  
Chairman of the Board and  
Chief Executive Officer

September 11, 2006

By: /s/ Arthur F. Trudel

-----

Edgar Filing: ARGAN INC - Form 10QSB

Arthur F. Trudel  
Senior Vice President,  
Chief Financial Officer and Secretary

34