

ACMAT CORPORATION AND SUBSIDIARIES
SEPTEMBER 30, 2008

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ACMAT CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets

<u>Assets</u>	September 30, <u>2008</u> (Unaudited)	December 31, <u>2007</u>
Investments:		
Fixed maturities-available for sale at fair value (Cost of \$65,646,553 in 2008 and \$65,672,276 in 2007)	\$63,374,422	64,211,281
Equity securities, at fair value (Cost of \$2,414,559 in 2008 and \$3,463,359 in 2007)	1,177,769	2,928,649
Short-term investments, at cost which approximates fair value	<u>14,122,694</u>	<u>28,088,375</u>
Total investments	78,674,885	95,228,305
Cash and cash equivalents	9,274,262	6,239,190
Accrued interest receivable	307,652	235,923
Receivables, net of allowance for doubtful accounts of \$101,231	1,935,964	2,193,739
Reinsurance recoverable:		
Unpaid losses	3,145,339	3,298,783
Paid losses	229,370	--
Prepaid expenses	342,528	191,511
Income tax receivable	329,056	340,865
Property & equipment, net	10,601,555	10,409,649
Deferred policy acquisition costs	718,413	1,011,123
Other assets	1,584,383	703,790
Intangibles	<u>1,920,360</u>	<u>1,920,360</u>
	<u>\$109,063,767</u>	<u>121,773,238</u>
 <u>Liabilities & Stockholders' Equity</u>		
Accounts payable	\$2,926,645	2,456,855
Reserves for losses and loss adjustment expenses	22,816,291	22,845,815
Unearned premiums	2,366,520	3,574,057
Collateral held	29,218,933	30,718,628
Deferred income taxes	91,337	111,225
Accrued liabilities	2,547,893	4,438,842
Long-term debt	<u>6,632,909</u>	<u>8,662,232</u>
Total liabilities	66,600,528	72,807,654
 Stockholders' Equity:		
Common Stock (No par value; 3,500,000 shares authorized; 472,412 and 478,692 shares issued and outstanding)	472,412	478,692
Class A Stock (No par value; 10,000,000 shares authorized; 1,090,360 and 1,315,960 shares issued and outstanding)	1,090,360	1,315,960
Retained earnings	44,440,839	49,188,831
Accumulated other comprehensive income (loss)	<u>(3,540,372)</u>	<u>(2,017,899)</u>
Total stockholders' equity	<u>42,463,239</u>	<u>48,965,584</u>
	<u>\$109,063,767</u>	<u>121,773,238</u>

See Notes to Unaudited Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES
Consolidated Statements of Earnings (Unaudited)

	Three months ended September 30		Nine months ended September 30	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Contract revenues	\$1,420,256	2,442,327	3,483,091	4,812,087
Earned premiums	2,004,632	2,200,811	6,088,731	7,575,651
Investment income, net	907,289	1,235,499	3,043,034	3,954,226
Net realized capital losses	(1,717,232)	(44,705)	(1,839,644)	(61,425)
Other income	<u>153,437</u>	<u>251,968</u>	<u>533,761</u>	<u>706,543</u>
	<u>2,768,382</u>	<u>6,085,900</u>	<u>11,308,973</u>	<u>16,987,082</u>
Cost of contract revenues	1,395,940	2,364,415	3,604,966	4,704,055
Losses and loss adjustment expenses	(782,436)	440,162	82,830	1,515,130
Amortization of policy acquisition costs	597,724	533,076	1,708,915	1,864,777
General and administrative expenses	994,096	1,151,836	3,379,095	3,638,783
Interest expense	<u>101,893</u>	<u>172,109</u>	<u>353,230</u>	<u>556,320</u>
	<u>2,307,217</u>	<u>4,661,598</u>	<u>9,129,036</u>	<u>12,279,065</u>
Earnings before income taxes	461,165	1,424,302	2,179,937	4,708,017
Income taxes	<u>410,415</u>	<u>513,873</u>	<u>1,028,040</u>	<u>1,623,547</u>
Net earnings	\$ <u>50,750</u>	<u>910,429</u>	<u>1,151,897</u>	<u>3,084,470</u>
Basic earnings per share	\$.03	.48	.69	1.65
Diluted earnings per share	\$.03	.45	.64	1.54

See Notes to Unaudited Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Unaudited)
September 30, 2008 and 2007

	Common Stock Par Value	Class A Stock Par Value	Retained Earnings	Accumulated Other Comprehensive Income(Loss)	Total Stockholders' Equity
Balance as of December 31, 2006	\$481,585	1,422,273	47,913,873	169,103	49,986,834
Comprehensive income:					
Net unrealized losses on debt and equity securities, net of reclassification	--	--	--	(789,818)	(789,818)
Net unrealized gains on derivatives qualifying as cash flow hedges	--	--	--	(52,058)	(52,058)
Net earnings	--	--	3,084,470	--	<u>3,084,470</u>
Total comprehensive income					2,242,594
Stock based compensation	--	--	95,474	--	95,474
Acquisition and retirement of 2,275 shares of Common Stock	(2,275)	--	(52,493)	--	(54,768)
Acquisition and retirement of 88,868 shares of Class A Stock	--	(88,868)	(2,230,794)	--	(2,319,662)
Issuance of 19,000 shares of Class A Stock pursuant to Stock Options	<u> --</u>	<u> 19,000</u>	<u> 163,480</u>	<u> --</u>	<u> 182,480</u>
Balance as of September 30, 2007	<u>\$479,310</u>	<u>1,352,405</u>	<u>48,974,010</u>	<u>(672,773)</u>	<u>50,132,952</u>
Balance as of December 31, 2007	\$478,692	1,315,960	49,188,831	(2,017,899)	48,965,584
Comprehensive income:					
Net unrealized losses on debt and equity securities, net of reclassification	--	--	--	(1,513,198)	(1,513,198)
Net unrealized gains on derivatives qualifying as cash flow hedges	--	--	--	(9,275)	(9,275)
Net earnings	--	--	1,151,897	--	<u>1,151,897</u>
Total comprehensive income					(370,576)
Stock based compensation	--	--	55,994	--	55,994
Acquisition and retirement of 6,280 shares of Common Stock	(6,280)	--	(162,650)	--	(168,930)
Acquisition and retirement of 225,600 shares of Class A Stock	<u> --</u>	<u> (225,600)</u>	<u>(5,793,233)</u>	<u> --</u>	<u>(6,018,833)</u>
Balance as of September 30, 2008	<u>\$472,412</u>	<u>1,090,360</u>	<u>44,440,839</u>	<u>(3,540,372)</u>	<u>42,463,239</u>

See Notes to Unaudited Consolidated Financial Statements.

Consolidated Statements of Cash Flows (Unaudited)
 Nine Months Ended September 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Net earnings	\$1,151,897	3,084,470
Adjustments to reconcile net earnings to net cash used for operating activities:		
Stock based compensation	55,994	95,474
Depreciation and amortization	276,429	187,894
Net realized capital losses	1,839,644	61,425
Changes in:		
Accrued interest receivable	(71,729)	(156,222)
Reinsurance recoverable	(75,926)	(419,739)
Receivables, net	257,775	(1,014,246)
Deferred policy acquisition costs	292,710	165,731
Prepaid expenses and other assets	(1,031,610)	999,369
Accounts payable and other accrued liabilities	(1,430,434)	637,921
Reserves for losses and loss adjustment expenses	(29,524)	630,553
Collateral held	(1,499,695)	(4,303,143)
Income taxes	(8,080)	(296,269)
Unearned premiums	<u>(1,207,537)</u>	<u>(837,784)</u>
Net cash used by operating activities	<u>(1,480,086)</u>	<u>(1,164,566)</u>
Cash flows from investing activities:		
Proceeds from investments sold or matured:		
Fixed maturities-sold	25,563,908	7,056,996
Fixed maturities-matured	--	3,716,000
Equity securities	--	3,290,232
Purchases of:		
Fixed maturities	(26,013,110)	(10,480,889)
Equity securities	(250,000)	(4,250,000)
Short-term investments, net	13,965,681	16,179,336
Capital expenditures	<u>(534,235)</u>	<u>(15,978)</u>
Net cash provided by investing activities	<u>12,732,244</u>	<u>15,495,697</u>
Cash flows from financing activities:		
Repayments on long-term debt	(2,029,323)	(1,894,051)
Issuance of Class A Stock	--	182,480
Payments for acquisition & retirement of stock	<u>(6,187,763)</u>	<u>(2,374,430)</u>
Net cash used for financing activities	<u>(8,217,086)</u>	<u>(4,086,001)</u>
Net change in cash	3,035,072	10,245,130
Cash at beginning of period	<u>6,239,190</u>	<u>7,584,783</u>
Cash at end of period	<u>\$9,274,262</u>	<u>\$17,829,913</u>

See Notes to Unaudited Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS:

(1) Financial Statements

The consolidated financial statements include the accounts of ACMAT Corporation ("ACMAT" or the "Company") and its subsidiaries. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and are unaudited.

The interim financial information contained in this report has been prepared from the books and records of the Company and its subsidiaries and reflects, in the opinion of the management of the Company, all adjustments (consisting of normal and recurring accruals) necessary to fairly present results of operations for the periods indicated. All significant intercompany accounts and transactions have been eliminated in consolidation.

These statements should be read in conjunction with the financial statements and notes thereto included in the Company's annual report for the year ended December 31, 2007.

(2) Adoption of New Accounting Standards

Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts

In September 2005, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, "Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments". SOP 05-1 defines an internal replacement as a modification of product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or order to a contract, or by the election of a feature or coverage within a contract. The adoption of SOP 05-1 effective January 1, 2007 did not have a material effect on operations, financial condition or liquidity.

Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes the recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Under FIN 48, evaluation of a tax position is a two-step process. The first step is to determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including the resolution of any related appeals or litigation based on the technical merits of the position. The second step is to measure a tax position that meets the more-likely-than-not threshold to determine the amount of benefit to be recognized in the financial statements. A tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent period in which the threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not criteria should be de-recognized in the first subsequent financial reporting period in which the threshold is no longer met.

The Company recognizes accrued interest and penalties, if any, related to unrecognized tax benefits in income taxes.

The Company does not have a liability nor does it expect any significant changes in unrecognized tax benefits during the next twelve months.

In May 2007, the FASB issued FASB Staff Position (FSP) FIN 48-1, Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1). The FSP addressed whether it is appropriate for a company to recognize a previously unrecognized tax benefit when the only factor that has changed, since determining that a benefit should not be recognized, was the completion of an examination or audit by a taxing authority. The FSP is effective January 1, 2007, the date the Company's initial adoption of FIN 48. The adoption of FSP Fin 48-1 did not have a material effect on the Company's results of operations, financial position or liquidity.

Accounting for Corporate-Owned Life Insurance

In September 2006, the FASB issued Emerging Issues Task Force Issue No. 06-5, Accounting for Purchase of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (EITF06-5). EITF 06-5 provides additional guidance on determining the amount that can be realized under a corporate-owned life insurance contract (that is, converted to cash) based upon how the contract is assumed to be hypothetically settled. The adoption of EITF 06-5 effective January 1, 2007 did not have a material effect on the Company's results of operations, financial position or liquidity.

Fair Value Measurements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure about fair value measurement. It applies to other pronouncements that require or permit fair value but does not require any new fair value measurements. The statement defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

FAS 157 establishes a fair value hierarchy to increase consistency and comparability in fair value measurements and disclosures. The hierarchy is based on the input used in valuation and gives the highest priority to quoted prices in active markets. The highest possible level should be used to measure fair value. FAS 157 is effective for fiscal years beginning after November 15, 2007.

In February 2008, FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2), which permits a one-year deferral of the application of FASB Statement No. 157, Fair Value Measurements for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

The Company adopted FAS 157 effective January 1, 2008. Accordingly, the provisions of FAS 157 were not applied to goodwill and other intangible assets held by the Company and will be measured annually for impairment testing purposes only. The Company is currently evaluating the impact of the adoption of FSP FAS 157-2. As allowed under FSP FAS 157-2, as of January 1, 2008, we have elected not to fully adopt SFAS 157 and are deferring adoption for certain non-financial assets and liabilities until January 1, 2009.

In October 2008, the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market For That Asset Is Not Active* (FSP FAS 157-3), with an immediate effective date, including prior periods for which financial statements have not been issued. FSP FAS 157-3 amends FAS 157 to clarify the application of fair value in inactive markets and allows for the use of management’s internal assumptions about future cash flows with appropriately risk-adjusted discount rates when relevant observable market data does not exist. The objective of FAS 157 has not changed and continues to be the determination of the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date. The adoption of FSP FAS 157-3 in the third quarter did not have a material effect on the Company’s results of operations, financial position or liquidity.

(3) Accounting Standards Not Yet Adopted

Determination of the Useful Life of Intangible Assets

In April 2008, the FASB issued FASB Staff Position (FSP) FAS 142-3, *Determination of the Useful Life of Intangible Assets*. The FSP amends the factors that an entity should consider in determining the useful life of a recognized intangible asset under FAS 142, *Goodwill and Other Intangible Assets*, to include the entity’s historical experience in renewing or extending similar arrangements, whether or not the arrangements have explicit renewal or extension provisions. Previously, an entity was precluded from using its own assumptions about renewal or extension of an arrangement where there was likely to be substantial cost or modifications. Entities without their own historical experience should consider the assumptions market participants would use about renewal or extension. The amendment may result in the useful life of an entity’s intangible asset differing from the period of expected cash flows that was used to measure the fair value of the underlying asset using the market participant’s perceived value. The FSP also requires disclosure in addition to that already required by FAS 142.

The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and for interim periods within those fiscal years. Early adoption is prohibited. The requirements for determining the useful life of intangible assets apply to intangible assets acquired after January 1, 2009. The disclosure requirements will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date.

Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAA 159). FAS 159 permits an entity to irrevocably elect fair value on a contract-by-contract basis as the initial and subsequent measurement attributed for many financial assets and liabilities and certain other items including property and casualty insurance contracts. Entities electing the fair value option would be required to recognize changes in fair value in earnings and to expense upfront costs and fees associated with the item for which the fair value option is elected. Entities electing the fair value option are required to distinguish on the face of the statement of financial position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. An entity can accomplish this by either reporting the fair value and non-fair value carrying amounts as separate line items or aggregate those amounts and disclose parenthetically the amount of fair value included in the aggregate amount.

FAS 159 is effective for fiscal years beginning after November 15, 2007. Upon adoption, an entity is permitted to elect the fair value option irrevocably for any existing asset or liability within the scope of the standard. The adjustment to reflect the difference between the fair value and the carrying amount would be accounted for as a cumulative-effect adjustment to retained earnings as of the date of initial adoption. Retrospective application would not be permitted. The Company did not elect the fair value option for assets and liabilities currently held upon its adoption of FAS 159 effective January 1, 2008. Therefore FAS 159 did not have an impact on the Company’s results of operations, financial condition or liquidity.

Collateral Assignment Split-Dollar Life Insurance Arrangements

In March 2007, the FASB issued Emerging Issues Task Force Issue No. 06-10, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements* (EITF 06-10). EITF 06-10 provides guidance on the recognition and measurement of assets related to collateral assignment split-dollar life insurance arrangements. The Company adopted provisions of EITF 06-10 effective January 1, 2008. EITF 06-10 did not have a material effect on its results of operations, financial condition or liquidity.

(4) Earnings Per Share

The following is a reconciliation of the numerators and denominators of the basic and diluted EPS computations for the three-month periods ended September 30, 2008 and 2007:

	<u>Earnings</u>	<u>Weighted Average Shares Outstanding</u>	<u>Per-Share Amount</u>
<u>2008:</u>			
Basic EPS:			
Earnings available to stockholders	\$50,750	1,595,248	\$0.03
Effect of Dilutive Securities:			
Stock options	<u> --</u>	<u> 133,764</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$50,750</u>	<u>1,729,012</u>	<u>\$0.03</u>
<u>2007:</u>			
Basic EPS:			
Earnings available to stockholders	\$910,429	1,882,967	\$0.48
Effect of Dilutive Securities:			
Stock options	<u> --</u>	<u> 137,431</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$910,429</u>	<u>2,020,398</u>	<u>\$0.45</u>

The following is a reconciliation of the numerators and denominators of the basic and diluted EPS computations for the nine-month periods ended September 30, 2008 and 2007:

	<u>Earnings</u>	<u>Weighted Average Shares Outstanding</u>	<u>Per-Share Amount</u>
<u>2008:</u>			
Basic EPS:			
Earnings available to stockholders	\$1,151,897	1,670,476	\$0.69
Effect of Dilutive Securities:			
Stock options	<u> --</u>	<u> 137,693</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$1,151,897</u>	<u>1,808,169</u>	<u>\$0.64</u>
<u>2007:</u>			
Basic EPS:			
Earnings available to stockholders	\$3,084,470	1,871,087	\$1.65
Effect of Dilutive Securities:			
Stock options	<u> --</u>	<u> 137,234</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$3,084,470</u>	<u>2,008,321</u>	<u>\$1.54</u>

(5) Supplemental Cash Flow Information

Income taxes paid during the nine months ended September 30, 2008 and 2007 was \$1,036,120 and \$1,919,674, respectively. Interest paid for the nine months ended September 30, 2008 and 2007 was \$358,125 and \$561,177, respectively.

(6) Comprehensive Income (Loss)

The following table summarizes reclassification adjustments for other comprehensive income (loss) and the related tax effects for the nine months ended September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Unrealized losses on investments:		
Unrealized holding gains (losses) arising during period	\$(3,352,842)	(851,243)
Less reclassification adjustment for losses included in net income	(1,839,644)	(61,425)
Unrealized gain (loss) on derivatives qualifying as cash flow hedges	<u>(9,275)</u>	<u>(52,058)</u>
Other comprehensive income (loss)	<u>\$(1,522,473)</u>	<u>(841,876)</u>

(7) Stock-Based Compensation

The Company periodically grants non-qualified stock options giving such individuals the right to purchase restricted shares of the Company's Common Stock and Class A Stock. The majority of the options outstanding to officers generally vest evenly over a five to ten year period and generally have a term of 10 years. The exercise price is equal to the fair value at the date of grant. The Company uses a variation of the Black-Scholes option pricing model to value stock options.

Compensation expense of \$55,994 and \$95,474 is reflected in net earnings for the nine months ended September 30, 2008 and 2007, respectively. The Company applied the recognition and measurement principles of SFAS 123R, Share Based Payment beginning January 1, 2006.

As of September 30, 2008 there were 359,000 stock options outstanding of which 62,667 were not yet vested. The compensation costs related to non-vested share compensation arrangements granted but not yet recognized was approximately \$70,000 as of September 30, 2008. The Company expects to recognize that cost over a weighted average period of 2.1 years.

(8) Investments

The amortized cost and estimated fair value of investments in fixed maturities classified as available for sale and equity securities at September 30, 2008 and December 31, 2007 were as follows:

	Amortized Cost	September 30, 2008		Fair Value
		Gross Gains	Gross Losses	
Fixed Maturities:				
States, municipalities and political subdivisions	\$ 788,191	--	29,655	758,536
U.S. Government and government agencies	26,270,687	230,916	19,732	26,481,871
Mortgage-backed securities	31,105,125	168,703	820,113	30,453,715
Industrial and miscellaneous	2,500,000	--	189,210	2,310,790
Redeemable preferred securities	<u>4,982,550</u>	<u>--</u>	<u>1,613,040</u>	<u>3,369,510</u>
	<u>\$65,646,553</u>	<u>399,619</u>	<u>2,671,750</u>	<u>63,374,422</u>
Equity Securities	<u>\$ 2,414,559</u>	<u>28,450</u>	<u>1,265,240</u>	<u>1,177,769</u>

	Amortized Cost	December 31, 2007		Fair Value
		Gross Gains	Gross Losses	
Fixed Maturities:				
States, municipalities and political subdivisions	\$ 738,060	214	5,272	733,002
U.S. Government and government agencies	14,022,728	644,350	2,810	14,664,268
Mortgage-backed securities	37,306,488	166,219	510,931	36,961,777
Industrial and miscellaneous	2,500,000	--	27,985	2,472,015
Redeemable preferred securities	<u>11,105,000</u>	<u>--</u>	<u>1,724,780</u>	<u>9,380,219</u>
	<u>\$65,672,276</u>	<u>810,783</u>	<u>2,271,778</u>	<u>64,211,281</u>
Equity Securities	<u>\$ 3,463,359</u>	<u>100,470</u>	<u>635,180</u>	<u>2,928,649</u>

Management has determined that the above unrealized losses were temporary.

(9) Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in FAS 157. The framework is based on the inputs used in valuation, gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates in the FAS 157 hierarchy is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

- Level 1 – Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.
- Level 2 – Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.
- Level 3 – Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

Valuation of Investments

For investments that have quoted market prices in active markets, the Company uses the quoted market prices as fair value and includes these prices in the amounts disclosed in Level 1 of the hierarchy. The Company receives the quoted market prices from a third party nationally recognized pricing service (pricing service). When quoted market prices are unavailable, the Company utilizes a pricing service to determine an estimate of fair value, which is mainly for its fixed maturity investments. The fair value estimates provided from this pricing service are included in the amount disclosed in Level 2 of the hierarchy. If quoted market prices and an estimate from a pricing service are unavailable, the Company produces an estimate of fair value based on internally developed valuation techniques, which, depending on the level of observable market inputs, will render the fair value estimate as Level 2 or Level 3. The Company bases all of its estimates of fair value for assets on the bid price as it represents what a third party market participant would be willing to pay in an arm's length transaction. The following section describes the valuation methods used by the Company for each type of financial instrument it holds that is carried at fair value.

Fixed Maturities

The Company utilizes a pricing service to estimate fair value measurements for all of its fixed maturities. The pricing service utilizes market quotations for fixed maturity securities that have quoted prices in active markets. Since fixed maturities other than U.S. Treasury securities generally do not trade on a daily basis, the pricing service prepares estimates of fair value measurements for these securities using its proprietary pricing applications which include available relevant market information, benchmark curves, benchmarking of like securities, sector groupings and matrix pricing.

The fair value estimates of most fixed maturity investments are based on observable market information rather than market quotes. Accordingly, the estimates of fair value for such fixed maturities, other than U.S. Treasury securities, provided by the pricing service are included in the amount disclosed in Level 2 of the hierarchy. The estimated fair value U.S. Treasury securities are included in the amount disclosed in Level 1 as the estimates are based on unadjusted market prices.

Equities

For public common and preferred stocks, the Company receives prices from a nationally recognized pricing service that are based on observable market transactions and includes these estimates in the amount disclosed in Level 1. Infrequently, current market quotes in active markets are unavailable for certain non-redeemable preferred stocks held by the Company. In these instances, the Company receives an estimate of fair value from the pricing service that provides fair value estimates for the Company's fixed maturities. The service utilizes some of the same methodologies to price the non-redeemable preferred stocks as it does for the fixed maturities. The Company includes the estimate in the amount disclosed in Level 2.

Fair Value Hierarchy

The following table presents the level within the fair value hierarchy at which the Company's financial assets and financial liabilities are measured on a recurring basis at September 30, 2008.

(in millions)	Total	Level 1	Level 2	Level 3
Invested assets;				
Fixed maturities	63,374,422	25,486,561	37,887,861	--
Equity securities	1,177,769	109,012	1,068,757	--
Short-term investments	<u>14,122,694</u>	<u>14,122,694</u>	<u>--</u>	<u>--</u>
Total	<u>78,674,885</u>	<u>39,718,267</u>	<u>38,956,618</u>	<u>--</u>

The following tables summarize, for all investments in an unrealized loss position at September 30, 2008 and December 31, 2007. The aggregate fair value and gross unrealized losses by length of time those securities have been continuously in an unrealized position.

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>
<u>September 30, 2008:</u>						
Fixed maturities:						
States, municipalities and political subdivisions	\$ 249,611	14,570	508,925	15,085	758,536	29,655
United States government and government agencies	10,064,250	19,732	--	--	10,064,250	19,732
Mortgage-backed securities	8,901,113	515,145	6,578,430	304,968	15,479,543	820,113
Industrial and miscellaneous	1,876,505	123,495	434,285	65,715	2,310,790	189,210
Redeemable preferred securities	<u>1,216,558</u>	<u>570,992</u>	<u>2,152,982</u>	<u>1,042,048</u>	<u>3,369,540</u>	<u>1,613,040</u>
Total fixed maturities	22,308,037	1,243,934	9,674,622	1,427,816	31,982,659	2,671,750
Equity securities – common stocks	--	--	--	--	--	--
Equity securities – perpetual preferred	<u>--</u>	<u>--</u>	<u>1,067,560</u>	<u>1,265,240</u>	<u>1,067,560</u>	<u>1,265,240</u>
Total equity	--	--	1,067,560	1,265,240	1,067,560	1,265,240
Total temporarily impaired securities	<u>\$22,308,037</u>	<u>1,243,934</u>	<u>10,742,182</u>	<u>2,692,546</u>	<u>33,050,219</u>	<u>3,936,990</u>

	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>	<u>Fair Value</u>	<u>Gross Unrealized Loss</u>
<u>December 31, 2007:</u>						
Fixed maturities:						
States, municipalities and political subdivisions	\$ --	--	523,105	5,272	523,105	5,272
United States government and government agencies	--	--	997,190	2,810	997,190	2,810
Mortgage-backed securities	7,635,167	245,702	8,631,897	265,229	16,267,064	510,931
Industrial and miscellaneous	--	--	2,472,015	27,985	2,472,015	27,985
Redeemable preferred securities	<u>8,415,490</u>	<u>1,524,510</u>	<u>964,730</u>	<u>200,270</u>	<u>9,380,220</u>	<u>1,724,780</u>
Total fixed maturities	16,050,657	1,770,212	13,588,937	501,566	29,639,594	2,271,778
Equity securities – common stocks	--	--	--	--	2,747,620	635,180
Equity securities – perpetual preferred	<u>2,747,620</u>	<u>635,180</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Total equity	2,747,620	625,180	--	--	2,747,620	635,180
Total temporarily impaired securities	<u>\$18,798,277</u>	<u>2,405,392</u>	<u>13,588,937</u>	<u>501,566</u>	<u>32,387,214</u>	<u>2,906,958</u>

(10) Segment Reporting

The Company has two reportable operating segments: ACMAT Contracting and ACSTAR Bonding. The Company's reportable segments are primarily the main legal entities of the Company, which offer different products and services. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

The Bonding operating segment provides surety bonds written for prime, specialty trade, environmental, asbestos and lead abatement contractors and miscellaneous obligations. ACSTAR also offers other miscellaneous surety such as workers' compensation bonds, supply bonds, subdivision bonds and license and permit bonds as well as some general liability.

ACMAT Contracting provides construction contracting services to commercial and governmental customers. ACMAT Contracting also provides underwriting services to its insurance subsidiaries. In addition, ACMAT Contracting owns a

commercial office building in New Britain Connecticut and leases office space to its insurance subsidiaries as well as third parties.

The Company evaluates performance based on earnings before income taxes and excluding interest expense. The Company accounts for intersegment revenue and expenses as if the products/services were to third parties. Information relating to the three segments for the three and nine-month periods ended September 30, 2008 and 2007 is summarized as follows:

	<u>Three Months ended</u>		<u>Nine Months ended</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Revenues:				
ACSTAR Bonding	\$1,584,867	3,136,651	7,236,039	10,663,672
ACMAT Contracting	<u>1,396,988</u>	<u>3,241,730</u>	<u>4,801,002</u>	<u>7,218,162</u>
	<u>\$2,981,855</u>	<u>6,378,381</u>	<u>12,037,041</u>	<u>17,881,834</u>
Operating Earnings (Loss):				
ACSTAR Bonding	\$1,406,450	1,731,532	4,154,989	5,835,944
ACMAT Contracting	<u>(843,392)</u>	<u>(135,121)</u>	<u>(1,621,822)</u>	<u>(571,607)</u>
	<u>\$ 563,058</u>	<u>1,596,411</u>	<u>2,533,167</u>	<u>5,264,337</u>
Depreciation and Amortization:				
ACSTAR Bonding	\$ (697)	(46,260)	(58,214)	(147,372)
ACMAT Contracting	<u>112,549</u>	<u>112,290</u>	<u>334,643</u>	<u>335,266</u>
	<u>\$111,852</u>	<u>66,030</u>	<u>276,429</u>	<u>187,894</u>
Identifiable Assets:	<u>September 30, 2008</u>		<u>December 31, 2007</u>	
ACSTAR Bonding	\$ 89,309,737		94,782,182	
ACMAT Contracting	<u>19,754,030</u>		<u>26,991,056</u>	
	<u>\$109,063,767</u>		<u>121,773,238</u>	

The components of revenue for each segment for the three and nine-month periods ended September 30, 2008 and 2007 are as follows:

	<u>Three Months ended</u>		<u>Nine Months ended</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
ACSTAR Bonding:				
Premiums	\$2,004,632	2,200,811	6,088,731	7,575,651
Investment income, net	755,362	1,023,397	2,473,918	3,222,122
Capital gains (losses)	(1,185,684)	(44,600)	(1,326,575)	(58,652)
Other	<u>10,557</u>	<u>(42,957)</u>	<u>(35)</u>	<u>(75,449)</u>
	<u>\$1,584,867</u>	<u>3,136,651</u>	<u>7,236,039</u>	<u>10,663,672</u>
ACMAT Contracting:				
Contract revenues	\$1,420,256	2,442,327	3,483,091	4,812,087
Investment income, net	78,975	139,083	357,074	506,413
Capital gains (losses)	(531,548)	(105)	(513,069)	(2,773)
Intersegment revenue:				
Rental income	79,149	79,149	237,448	237,448
Underwriting services, agency commissions and funds administration services	252,906	431,834	900,839	1,296,883
Other	<u>97,250</u>	<u>149,442</u>	<u>335,619</u>	<u>368,104</u>
	<u>\$1,396,988</u>	<u>3,241,730</u>	<u>4,801,002</u>	<u>7,218,162</u>

The following is a reconciliation of segment totals for revenue and operating income to corresponding amounts in the Company's statement of earnings:

	<u>Three Months ended</u>		<u>Nine Months ended</u>	
	<u>2008</u>	<u>2007</u>	<u>2007</u>	<u>2006</u>
Revenue:				
Total revenue for reportable segments	\$2,981,855	6,378,381	12,037,041	17,881,834
Intersegment eliminations	<u>(213,473)</u>	<u>(292,481)</u>	<u>(728,068)</u>	<u>(894,752)</u>
	<u>\$2,768,382</u>	<u>6,085,900</u>	<u>11,308,973</u>	<u>16,987,082</u>

The adjustments and eliminations required to arrive at consolidated amounts shown above consist principally of the elimination of the intersegment revenues related to the performance of certain services and rental charges. Identifiable assets are those assets that are used by each segment's operations. Foreign revenues are not significant.

Operating Earnings:	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Total operating earnings for reportable segments	\$563,058	1,596,411	2,533,167	5,264,337
Interest expense	<u>(101,893)</u>	<u>(172,109)</u>	<u>(353,230)</u>	<u>(556,320)</u>
	<u>\$461,165</u>	<u>1,424,302</u>	<u>2,179,937</u>	<u>4,708,017</u>

Operating earnings for ACMAT contracting are operating revenues less cost of contract revenues and identifiable selling, general and administrative expenses. Operating earnings for the bonding and liability insurance segments are revenues less losses and loss adjustment expenses, amortization of policy acquisition costs and identifiable, general and administrative expenses.