

ACMAT CORPORATION AND SUBSIDIARIES  
DECEMBER 31, 2008

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**ACMAT CORPORATION AND SUBSIDIARIES**

Consolidated Statements of Earnings  
Years Ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Earned premiums	\$7,590,974	10,159,139
Contract revenues	4,590,997	5,676,191
Investment income, net	3,872,781	5,242,249
Net realized capital losses	(2,011,496)	(79,581)
Other income	<u>912,221</u>	<u>959,268</u>
	14,955,477	21,957,266
Cost of contract revenues	4,339,573	5,623,428
Losses and loss adjustment expenses	313,339	2,031,828
Amortization of policy acquisition costs	2,117,741	2,535,706
General and administrative expenses	4,710,923	4,920,525
Interest expense	<u>449,553</u>	<u>725,485</u>
	11,931,129	15,836,972
Earnings before income taxes	3,024,348	6,120,294
Income taxes	<u>1,069,889</u>	<u>2,003,797</u>
Net earnings	<u>\$1,954,459</u>	<u>4,116,497</u>
Basic earnings per share	\$ <u>1.19</u>	<u>2.21</u>
Diluted earnings per share	\$ <u>1.10</u>	<u>2.06</u>

See Notes to Consolidated Financial Statements.

**ACMAT CORPORATION AND SUBSIDIARIES**

Consolidated Balance Sheets  
December 31, 2008 and 2007

<u>Assets</u>	<u>2008</u>	<u>2007</u>
Investments:		
Fixed maturities – available for sale at fair value (Amortized cost of \$60,797,261 in 2008 and \$65,672,276 in 2007)	\$ 59,701,247	64,211,281
Equity securities – available for sale at fair value (Cost of \$1,913,359 in 2008 and \$3,463,359 in 2007)	995,722	2,928,649
Short-term investments, at cost which approximates fair value	<u>15,963,120</u>	<u>28,088,375</u>
Total Investments	76,660,089	95,228,305
Cash and cash equivalents	12,554,590	6,239,190
Accrued interest receivable	338,486	235,923
Receivables, net of allowance for doubtful accounts of \$71,231 in 2008 and \$101,231 in 2007	1,323,415	2,193,739
Reinsurance recoverable:		
Unpaid losses	3,530,878	3,298,783
Paid losses	98,652	--
Prepaid expenses	192,317	191,511
Income taxes receivable	1,004,764	340,865
Property and equipment, net	10,644,847	10,409,649
Deferred policy acquisition costs	940,700	1,011,123
Other assets	1,054,957	703,790
Intangibles	<u>1,920,360</u>	<u>1,920,360</u>
Total Assets	<u>\$110,264,055</u>	<u>121,773,238</u>
<u>Liabilities &amp; Stockholders' Equity</u>		
Accounts payable	\$ 1,923,689	2,456,855
Reserves for losses and loss adjustment expenses	23,064,539	22,845,815
Unearned premiums	2,911,613	3,574,057
Collateral held	28,541,360	30,718,628
Deferred income taxes	234,887	111,225
Other accrued liabilities	3,088,431	4,438,842
Long-term debt	<u>6,037,427</u>	<u>8,662,232</u>
Total Liabilities	65,801,946	72,807,654
Stockholders' Equity:		
Common Stock (No par value; 3,500,000 shares authorized; 471,606 and 478,692 shares issued and outstanding)	471,606	478,692
Class A Stock (No par value; 10,000,000 shares authorized; 1,089,193 and 1,315,960 shares issued and outstanding)	1,089,193	1,315,960
Retained earnings	45,001,854	49,188,831
Accumulated other comprehensive loss	<u>(2,100,544)</u>	<u>(2,017,899)</u>
Total Stockholders' Equity	<u>44,462,109</u>	<u>48,965,584</u>
	<u>\$110,264,055</u>	<u>121,773,238</u>

See Notes to Consolidated Financial Statements.

**ACMAT CORPORATION AND SUBSIDIARIES**

Consolidated Statements of Stockholders' Equity  
December 31, 2008 and 2007

	<u>Common Stock par value</u>	<u>Class A Stock par value</u>	<u>Retained earnings</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Total stockholders' equity</u>
Balance as of December 31, 2006	\$481,585	1,422,273	47,913,873	169,103	49,986,834
Comprehensive income:					
Net unrealized loss on debt and equity securities, net of reclassification adjustment	---	---	---	(2,085,081)	(2,085,081)
Net unrealized loss on derivatives qualifying as hedges	---	---	---	(101,921)	(101,921)
Net earnings	---	---	4,116,497	---	<u>4,116,497</u>
Total comprehensive income					1,929,495
Stock based compensation	---	---	117,420	---	117,420
Acquisition and retirement of 2,893 shares of Common Stock	(2,893)	---	(68,097)	---	(70,990)
Acquisition and retirement of 125,313 shares of Class A Stock	---	(125,313)	(3,164,339)	---	(3,289,652)
Issuance of 19,000 shares of Class A Stock pursuant to stock options	---	<u>19,000</u>	<u>273,477</u>	---	<u>292,477</u>
Balance as of December 31, 2007	<u>\$478,692</u>	<u>1,315,960</u>	<u>49,188,831</u>	<u>(2,017,899)</u>	<u>48,965,584</u>
Comprehensive income:					
Net unrealized loss on debt and equity securities, net of reclassification adjustment	\$ ---	---	---	(17,942)	(17,942)
Net unrealized loss on derivatives qualifying as hedges	---	---	---	(64,703)	(64,703)
Net earnings	---	---	1,954,459	---	<u>1,954,459</u>
Total comprehensive income					1,871,814
Stock based compensation	---	---	70,461	---	70,461
Acquisition and retirement of 7,086 shares of Common Stock	(7,086)	---	(183,050)	---	(190,136)
Acquisition and retirement of 246,267 shares of Class A Stock	---	(246,267)	(6,304,949)	---	(6,551,216)
Issuance of 19,500 shares of Class A Stock pursuant to stock options	---	<u>19,500</u>	<u>276,102</u>	---	<u>295,602</u>
Balance as of December 31, 2008	<u>\$471,606</u>	<u>1,089,193</u>	<u>45,001,854</u>	<u>(2,100,544)</u>	<u>44,462,109</u>

See Notes to Consolidated Financial Statements.

**ACMAT CORPORATION AND SUBSIDIARIES**

Consolidated Statements of Cash Flows  
Years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Cash Flows From Operating Activities:</b>		
Net earnings	\$1,954,459	4,116,497
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Stock based compensation expense	70,461	117,420
Depreciation and amortization	395,745	253,216
Net realized capital losses	2,011,496	79,581
Deferred income taxes	123,662	115,773
Changes In:		
Accrued interest receivable	(102,563)	34,487
Receivables	870,324	(1,301,693)
Reinsurance recoverable	(330,747)	(300,903)
Deferred policy acquisition costs	70,423	190,098
Prepaid expenses and other assets	(840,835)	1,145,217
Accounts payable and other liabilities	(1,459,418)	2,682,469
Collateral held	(2,177,268)	(5,828,900)
Reserves for losses and loss adjustment expenses	218,724	765,514
Income taxes	(663,900)	(640,626)
Unearned premiums	(662,444)	(1,062,580)
Other	---	(32,626)
Net cash provided by (used for) operating activities	<u>(521,881)</u>	<u>332,944</u>
<b>Cash Flows From Investing Activities:</b>		
Proceeds from investments sold or matured:		
Fixed maturities – sold	53,895,552	12,354,015
Fixed maturities – matured	275,000	3,716,000
Equity securities	1,080,647	978,000
Purchases Of:		
Fixed maturities	(50,136,781)	(14,730,889)
Equity securities	(628,000)	---
Short-term investments, (purchases) sales, net	12,125,255	1,884,516
Capital expenditures	<u>(703,837)</u>	<u>(167,958)</u>
Net cash provided by investing activities	<u>15,907,836</u>	<u>4,033,684</u>
<b>Cash Flows From Financing Activities:</b>		
Repayments on long-term debt	(2,624,805)	(2,644,056)
Issuance of Common and Class A Stock	186,700	182,480
Tax benefit from exercise of stock options	108,902	109,997
Payments for acquisition and retirement of stock	<u>(6,741,352)</u>	<u>(3,360,642)</u>
Net cash used for financing activities	<u>(9,070,555)</u>	<u>(5,712,221)</u>
Net change in cash and cash equivalents	6,315,400	(1,345,593)
Cash and cash equivalents, beginning of year	<u>6,239,190</u>	<u>7,584,783</u>
Cash and cash equivalents, end of year	<u>\$12,554,590</u>	<u>6,239,190</u>

See Notes to Consolidated Financial Statements.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008 and 2007**

**(1) Summary of Significant Accounting Policies**

(a) Basis of Presentation

The consolidated financial statements include ACMAT Corporation ("ACMAT" or the "Company"), its subsidiaries, including AMINS, Inc., ACSTAR Holdings, Inc. ("ACSTAR Holdings") and ACSTAR Holdings' wholly-owned subsidiary, ACSTAR Insurance Company ("ACSTAR").

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and claims and expenses during the reporting period. Actual results could differ from those estimates. Certain reclassifications have been made to prior years' financial statements to conform to the current year's presentation. All material intercompany transactions and balances have been eliminated.

(b) Business

The Company has two reportable operating segments: ACMAT Contracting and ACSTAR Bonding. The Company's reportable segments are primarily the 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 contractors, specialty trade, environmental remediation and asbestos abatement contractors and others. ACSTAR also offers other miscellaneous surety such as workers' compensation bonds, supply bonds, subdivision bonds and license and permit bonds.

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 subsidiary as well as to third parties.

During 2008 and 2007, customers who individually accounted for more than 10% of consolidated construction contracting revenue are as follows; in 2008 – 2 customers provided 57% and 43%, respectively and in 2007 - three customers provided 43%, 43% and 10%, respectively.

(c) Investments

Fixed maturities include bonds, notes and redeemable preferred stocks. Equity securities reflect investment in common stock, non-redeemable preferred stock and mutual funds. Investments are classified as "available for sale" and are reported at fair value, with unrealized gains or losses, net of tax, charged or credited directly to stockholders' equity.

The fair values of investment securities are based on quoted market prices and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Premiums and discounts on debt securities are amortized into interest income over the term of the securities in a manner that approximates the interest method. Realized gains and losses on sales of securities are computed using the specific identification method. Any security which management believes has experienced a decline in value which is other than temporary is written down to its fair value and a charge is recorded in net realized capital gains. The risks inherent in assessing the impairment of an investment security include the risk that market factors may differ from expectations and may change over time. Unexpected changes to these factors and circumstances in the future may result in a decision to sell or impair securities that were not impaired in prior reporting periods.

Short-term investments, consisting primarily of treasury bills maturing within one year are carried at cost which, along with accrued interest, approximates fair value. Cash and cash equivalents include cash on hand and short-term highly liquid investments of maturities of three months or less when purchased. These investments are carried at cost plus accrued interest which approximates fair value.

An investment in a debt or equity security is other-than-temporarily impaired if its fair value falls below its book value and the decline is considered to be other-than-temporary. Factors considered in determining whether a decline is other-than-temporary include the length of time and the extent to which fair value has been below cost, the financial condition and the near-term prospects of the issuer; and the Company's ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery.

## ACMAT CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

If management determines that the fair value of its securitized financial asset is less than its carrying amount and there has been a decrease in the present value of the estimated cash flows since the last revised estimate, considering both timing and amount, then an other-than-temporary impairment charge is recognized. A debt security is impaired if it is probable that the Company will not be able to collect all amounts due under the security's contractual terms. Equity investments are impaired when it becomes apparent that the Company will not recover its cost over the expected holding period and consideration is given to the financial condition of the issue. Further, for securities expected to be sold, an other-than-temporary impairment charge is recognized if the Company does not expect the fair value of a security to recover the cost prior to the expected date of sale.

The Company's process for reviewing invested assets for impairments includes the following:

- Identification and evaluation of investments which have possible indications of impairment;
- Analysis of investments with gross unrealized investment losses that have fair value less than 80% of amortized cost during successive quarterly periods over a rolling one-year period;
- Management review of other-than-temporary impairments based on the investee's current financial condition, liquidity, near term recovery prospects and other factors, as well as consideration of other investments that were not recommended for other-than-temporary impairments;
- Consideration of evidential matter, including an evaluation of factors or triggers that would or could cause individual investments to qualify as having other-than-temporary impairment and those that would not support other-than-temporary impairments; and
- Determination of the status of each analyzed investment as other-than-temporary or not, with documentation of the rationale for the decision.

#### (d) Deferred Policy Acquisition Costs

Deferred policy acquisition costs, representing commissions and certain underwriting costs, are deferred and amortized pro rata over the contract periods in which the related premiums are earned. Deferred acquisition costs are reviewed to determine if they are recoverable from future income, and if not, are charged to expense. Future investment income attributable to related premiums is taken into account in measuring the recoverability of the carrying value of this asset.

#### (e) Property and Equipment

Property and equipment are stated at cost net of depreciation. Depreciation is computed using the straight-line method at rates based upon the respective estimated useful lives of the assets. Maintenance and repairs are expensed as incurred.

#### (f) Intangibles

Intangible assets relate to insurance operating licenses that are deemed to have an indefinite useful life. The Company performs an impairment test at least annually or more frequently if events or conditions indicate that the asset might be impaired. Based on these tests, the Company did not impair any intangible assets.

#### (g) Insurance Reserve Liabilities

Reserves for losses and loss adjustment expenses are established with respect to both reported and incurred but not reported claims for insured risks. The amount of loss reserves for reported claims is primarily based upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding the claim and the policy provisions relating to the type of claim. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Reserves are monitored and recomputed periodically using new information on reported claims.

Reserves for losses and loss adjustment expenses are estimates at any given point in time of what the Company may have to pay ultimately on incurred losses, including related settlement costs, based on facts and circumstances then known. The Company also reviews its claims reporting patterns, past loss experience, risk factors and current trends and considers their effect in the determination of estimates of incurred but not reported losses. Ultimate losses and loss adjustment expenses are affected by many factors which are difficult to predict, such as claim severity and frequency, inflation levels and unexpected and unfavorable judicial rulings. Reserves for surety claims also consider the amount of collateral held as well as the financial strength of the contractor and its indemnitors. Management believes that the reserves for losses and loss adjustment expenses are adequate to cover the unpaid portion of the ultimate net cost of losses and loss adjustment expenses incurred, including losses incurred but not reported.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(h) Collateral Held

Collateral held represents cash and investments retained by the Company for surety bonds issued by the Company to cover costs of claims or unpaid premiums. The carrying amount of collateral held approximates its fair value because of the short maturity of these instruments.

(i) Reinsurance

In the normal course of business, the Company may assume and cede reinsurance with other companies. Reinsurance ceded primarily represents excess of loss reinsurance with companies with "A" ratings from the insurance rating organization, A.M. Best Company, Inc. Reinsurance ceded also includes a facultative reinsurance treaty which is applicable to excess policies written over a primary policy issued by the Company for specific projects. Reinsurance is ceded to limit losses from large exposures and to permit recovery of a portion of direct losses; however, such a transfer does not relieve the originating insurer of its liability.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured business. The Company evaluates and monitors the financial condition of reinsurers under reinsurance arrangements to determine its exposure to significant losses from reinsurer insolvencies.

The Company cedes 80% of its bond exposure in excess of \$1,000,000 up to \$7,000,000 on a per principal basis.

Reinsurance recoverables include ceded reserves for losses and loss adjustment expenses. Ceded unearned premiums of \$317,508 and \$507,520 at December 31, 2008 and 2007 respectively, are included in other assets. All reinsurance contracts maintained by the Company qualify as short-duration prospective contracts. A summary of reinsurance premiums written and earned is provided below:

	<u>Premiums Written</u>		<u>Premiums Earned</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Direct	\$8,286,189	10,754,715	\$8,918,784	11,788,853
Assumed	--	56,250	29,847	84,694
Ceded	<u>(1,167,645)</u>	<u>(1,578,553)</u>	<u>(1,357,657)</u>	<u>(1,714,408)</u>
Totals	<u>\$7,118,544</u>	<u>9,232,412</u>	<u>\$7,590,974</u>	<u>10,159,139</u>

Ceded incurred losses and loss adjustment expenses totaled \$56,041 and \$342,882 for the years ended December 31, 2008 and 2007, respectively.

(j) Derivative Financial Instruments

The Company uses interest rate swaps as a means of hedging exposure to interest rate on its long-term debt. The Company does not hold or issue derivative instruments for trading purposes. The Company recognizes all derivatives as either assets or liabilities in the consolidated balance sheet and measures those instruments at fair value. Where applicable, hedge accounting is used to account for derivatives. To qualify for hedge accounting, the changes in value of the derivative must be expected to substantially offset the changes in value of the hedged item. Hedges are monitored to ensure that there is a high correlation between the derivative instruments and the hedged investment. Derivatives that do not qualify for hedge accounting, if any, would be marked to market with the changes in fair value reflected in the consolidated statement of earnings.

(k) Revenue Recognition

Revenue on construction contracts is recorded using the percentage of completion method. Under this method revenues with respect to individual contracts are recognized in the proportion that costs incurred to date relate to total estimated costs. Revenues and cost estimates are subject to revision during the terms of the contracts, and any required adjustments are made in the periods in which the revisions become known. Provisions are made, where applicable, for the entire amount of anticipated future losses on contracts in progress. Construction claims are recorded as revenue at the time of settlement and profit incentives and change orders are included in revenues when their realization is reasonably assured. General and administrative expenses are not allocated to contracts.

Insurance premiums are recognized over the coverage period. Unearned premiums represent the portion of premiums written that is applicable to the unexpired terms of policies in force, calculated on a pro-rata basis.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(l) Income Taxes

The provision for taxes comprises two components, current income taxes and deferred income taxes. Deferred income taxes arise from changes during the year in cumulative temporary differences between the tax basis and book basis of assets and liabilities.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that all or some portion of the deferred tax assets will not be realized.

(m) Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from reported results using those estimates.

(n) Comprehensive Income

The following table summarizes reclassification adjustments for other comprehensive income and the related tax effects for the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Unrealized holding loss arising during period, net of income tax expense	\$(1,345,529)	(2,137,604)
Less reclassification adjustment for losses included in net earnings, net of income tax benefit of \$683,909 in 2008 and \$27,058 in 2007	(1,327,587)	(52,523)
Unrealized loss on derivatives qualifying as cash flow hedges	<u>( 64,703)</u>	<u>(101,921)</u>
Other comprehensive income (loss)	<u>\$ (82,645)</u>	<u>\$(2,187,002)</u>

(o) Stock – Based Compensation

The Company periodically grants non-qualified stock options to officers and directors giving such individuals the right to purchase restricted shares of the Company's Common Stock and Class A Stock. Compensation cost is measured based on the grant-date fair value of the award determined pursuant to FAS 123R, Share Based Payment, utilizing the assumptions discussed in note 14. Compensation cost is recognized for financial reporting purposes over the period in which the employee is required to provide service in exchange for the award (the vesting period).

(p) Adoption of New Accounting Standards

**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 nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

## **ACMAT CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The Company adopted FAS 157 and FSP FAS 157-2 effective January 1, 2008. The adoption of FAS 157 and FSP FAS 157-2 did not have an effect on the Company's results of operations, financial position or liquidity. The Company will adopt FAS 157 for non financial liabilities on January 1, 2009 and does not expect the provisions to have a material effect on the Company's results of operations, financial position or liquidity.

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 did not have an effect on the Company's results of operations, financial position or liquidity.

### **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* (FAS 159). FAS 159 permits an entity to irrevocably elect fair value on a contract-by-contract basis as the initial and subsequent measurement attribute 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 up-front 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 aggregating those amounts and disclosing 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 position 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. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. The adoption of EITF 06-10 effective January 1, 2008 did not have an effect on its results of operations, financial position or liquidity.

(q) 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 to provide information on an entity's intent and/or ability to renew or extend the arrangement.

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.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Fair Value Measurements – Assessing Fair Value in Market Conditions that are Not Orderly**

In April 2009, the FASB released FSP No. FAS 157-4 “*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.*” This FSP provides guidance as to how to determine the fair value of assets and liabilities in distressed economic conditions. It also amends the disclosure requirements of FAS 157 “*Fair Value Measurements*” to require greater disaggregation of debt and equity securities. FSP FAS 157-4 will be effective for us on June 30, 2009. We are currently assessing the impact of this FSP to our financial position and results of operations.

**Recognition and Presentation of Other-Than-Temporary Impairments**

Also in April 2009, the FSASB released FSP No. FAS 115-2 and FAS 124-2, “*Recognition and Presentation of Other-Than-Temporary Impairment.*” This FSP amends the accounting for other-than-temporary impairments (“OTTI”) by establishing new criteria for the recognition of OTTI on debt securities and also requiring additional financial statement disclosure. This FSP is effective for us on June 30, 2009. We are currently assessing the impact of this FSP to our financial position and results of operations.

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**(2) Investments**

Investments at December 31, 2008 and 2007 follows:	AMORTIZED COST	GROSS UNREALIZED GAINS      LOSSES		FAIR VALUE
<u>2008</u>				
Fixed maturities – available for sale:				
Bonds:				
States, municipalities and political subdivisions	\$ 8,335,774	209,436	(52,551)	8,492,659
United States government and government agencies	9,727,287	384,292	--	10,111,579
Mortgage-backed securities	30,939,508	433,264	(1,392,528)	29,980,244
Industrial and miscellaneous	7,827,142	98,532	(156,919)	7,768,755
Redeemable preferred stock	<u>3,967,550</u>	<u>--</u>	<u>(619,540)</u>	<u>3,348,010</u>
Total fixed maturities	60,797,261	1,125,524	(2,221,538)	59,701,247
Equity securities – common stocks:				
Banks, trusts and insurance	80,559	1,362	(10,299)	71,622
Equity securities - perpetual preferreds:				
Banks, trusts and insurance	<u>1,832,800</u>	<u>--</u>	<u>(908,700)</u>	<u>924,100</u>
Total equity securities	1,913,359	1,362	(918,999)	995,722
Short-term investments	<u>15,963,120</u>	<u>--</u>	<u>--</u>	<u>15,963,120</u>
Total investments	<u>\$78,673,740</u>	<u>1,126,886</u>	<u>(3,140,537)</u>	<u>76,660,089</u>
	AMORTIZED COST	GROSS UNREALIZED GAINS      LOSSES		FAIR VALUE
<u>2007</u>				
Fixed maturities – available for sale:				
Bonds:				
States, municipalities and political subdivisions	\$ 738,060	214	(5,272)	733,002
United States 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 stock	<u>11,105,000</u>	<u>--</u>	<u>(1,724,780)</u>	<u>9,380,219</u>
Total fixed maturities	65,672,276	810,783	(2,271,778)	64,211,281
Equity securities - common stocks:				
Banks, trusts and insurance	80,559	100,470	--	181,029
Equity securities - perpetual preferreds:				
Industrial and miscellaneous	<u>3,382,800</u>	<u>--</u>	<u>(635,180)</u>	<u>2,747,620</u>
Total equity securities	3,463,359	100,470	(635,180)	2,928,649
Short-term investments	<u>28,088,375</u>	<u>--</u>	<u>--</u>	<u>28,088,375</u>
Total investments	<u>\$97,224,010</u>	<u>911,253</u>	<u>(2,906,958)</u>	<u>95,228,305</u>

On December 31, 2008 and 2007, the Company's insurance subsidiary had securities with an aggregate fair value of approximately \$4.3 million deposit with various state regulatory authorities.

The amortized cost and fair value of fixed maturities at December 31, 2008, by effective maturity, follows:

	2008	
	Amortized Cost	Fair Value
Due in one year or less	\$ 685,555	678,689
Due after one year through five years	17,028,676	17,448,864
Due after five years through ten years	5,772,108	5,772,057
Due after ten years	6,371,414	5,821,393
Mortgage-backed securities	<u>30,939,508</u>	<u>29,980,244</u>
Total	<u>\$60,797,261</u>	<u>59,701,247</u>

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Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The Company's fixed maturity portfolio is comprised primarily of fixed maturity securities rated AA or better by Standard and Poor's and includes mostly U.S. Treasuries and mortgage-backed securities.

The Company makes investments in residential collateralized mortgage obligations (CMOs) that typically have high credit quality, offer good liquidity and are expected to provide an advantage in yield compared to U.S. Treasury securities. The Company's investment strategy is to purchase CMO tranches which offer the most favorable return given the risks involved. One significant risk evaluated is prepayment sensitivity. While prepayment risk (either shortening or lengthening of duration) and its effect on total return cannot be fully controlled, particularly when interest rates move dramatically, the investment process generally favors securities that control this risk within expected interest rate ranges. The Company does invest in other types of CMO tranches if a careful assessment indicates a favorable risk/return tradeoff. The Company does not purchase residual interests in CMOs.

At December 31, 2008 and 2007, the Company held CMOs classified as available for sale with a fair value of \$29,978,938 and \$36,920,692, respectively. Approximately 83% and 84% of the Company's CMO holdings are fully collateralized by GNMA, FNMA or FHLMC securities at December 31, 2008 and 2007, respectively. In addition, the Company held \$1,305 and \$41,085 of FNMA mortgage-backed pass-through securities classified as available for sale at December 31, 2008 and 2007, respectively. The average credit rating of all of the above securities was "Aaa" at both dates.

The unrealized losses on the Company's investments in mortgage-backed securities were caused by a combination of factors during 2008 related to the market disruption caused by credit concerns surrounding the sub-prime issue, but also extended into other asset-backed securities in the market and specifically in the Company's portfolio.

The majority of the holdings in the mortgage-backed security category includes mortgage-backed securities guaranteed by an agency of the U.S. Government. There were 6 agency mortgage-backed securities in an unrealized loss position of \$40,867 as of December 31, 2008. The aggregate severity of the unrealized losses on these securities was less than 1% of amortized cost. These securities do not tend to be influenced by the credit of the issuer but rather the characteristics and projected cash flows of the underlying collateral.

The remainder of the holdings in this mortgage-backed security category are collateralized mortgage obligations (CMOs) typically collateralized with prime residential mortgages and corporate asset-backed structured securities. The holdings in these sectors include 8 securities in a gross unrealized loss position of \$1,351,661. The aggregate severity of the unrealized loss was approximately 22% of amortized cost.

The Company believes the decline in fair value was primarily attributable to the market disruption caused by sub-prime related issues and other temporary market conditions. Because the Company has the ability and intent to hold these investments until an anticipated recovery of fair value, which may be maturity, and management's assessment of the expected losses in the underlying collateral shows no loss in principal or interest, the Company considers these investments to be temporarily impaired at December 31, 2008.

The unrealized losses on the Company's investments in redeemable preferred stock were caused by similar factors as those that affected the Company's corporate bond portfolio. The holdings in this category have been adversely impacted by significant credit spread widening brought on by a combination of factors in the capital markets. Many of the securities in this category have fallen out of favor in the current market conditions. Virtually all of the gross unrealized losses in this category come from securities issued by diversified financial institutions. The holdings in this category include 9 securities in a gross unrealized loss position of \$619,540. The aggregate severity of the unrealized losses on these securities was approximately 16% of amortized costs. The Company believes the decline in fair value was primarily due to the market disruption caused by sub-prime related issues and other temporary market conditions. We considered factors such as the quality of the investment security, whether the investments were performing assets and currently receiving interest, dividends and principal payments, the credit quality of the issuer and the investment's current prospects for recovery. Because the Company has the ability and intent to hold these investments until an anticipated recovery of fair value, which may be maturity, the Company considers these investments to be temporarily impaired at December 31, 2008. The unrealized losses on the Company's investments in perpetual preferred securities were caused by similar factors as those that affected the Company's fixed maturities. Many of the securities in this category have fallen out of favor in the current market condition. All of the gross unrealized losses in this category come from five securities issued by diversified financial institutions.

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The gross unrealized investment losses and related fair value for fixed maturities and equity securities at December 31, 2008 and 2007 were as follows:

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total 2008</u>	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Fixed maturities:						
States, municipalities and political subdivisions	\$251,495	12,617	482,595	39,934	734,090	52,551
United States government and government agencies	--	--	--	--	--	--
Mortgage-backed securities	3,372,538	466,418	6,100,500	926,110	9,473,038	1,392,528
Industrial and miscellaneous	4,191,100	126,664	469,745	30,255	4,660,845	156,919
Redeemable preferred stock	<u>997,600</u>	<u>2,400</u>	<u>2,350,410</u>	<u>617,140</u>	<u>3,348,010</u>	<u>619,540</u>
Total fixed maturities	8,812,733	608,099	9,403,250	1,613,439	18,215,983	2,221,538
Equity securities – common stocks	64,998	10,299	--	--	64,998	10,299
Equity securities – perpetual preferred	<u>--</u>	<u>--</u>	<u>924,100</u>	<u>908,700</u>	<u>924,100</u>	<u>908,700</u>
Total equity securities	<u>64,998</u>	<u>10,299</u>	<u>924,100</u>	<u>908,700</u>	<u>989,098</u>	<u>918,999</u>
Total temporarily impaired securities	<u>\$8,877,731</u>	<u>618,398</u>	<u>10,327,350</u>	<u>2,522,139</u>	<u>19,205,081</u>	<u>3,140,537</u>

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total 2007</u>	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
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 stock	<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	--	--	--	--	--	--
Equity securities – perpetual preferred	<u>2,747,620</u>	<u>635,180</u>	<u>--</u>	<u>--</u>	<u>2,747,620</u>	<u>635,180</u>
Total equity securities	<u>2,747,620</u>	<u>635,180</u>	<u>--</u>	<u>--</u>	<u>2,747,620</u>	<u>635,180</u>
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>

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A summary of net investment income for the years ended December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Tax-exempt interest	\$ 68,895	24,444
Taxable interest	3,169,086	4,288,455
Dividends on equity securities	673,301	952,202
Investment expenses	<u>(38,501)</u>	<u>(22,852)</u>
Net investment income	<u>\$3,872,781</u>	<u>5,242,249</u>

Net realized capital losses for the years ended December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Fixed maturities	\$ (914,183)	(63,181)
Equity securities	<u>(1,097,313)</u>	<u>(16,400)</u>
Net realized capital losses	<u>\$(2,011,496)</u>	<u>(79,581)</u>

Proceeds from sales of fixed maturities classified as available for sale were \$53,895,552 and \$12,354,015 in 2008 and 2007, respectively. Gross gains of \$1,359,723 and \$8,733 and gross losses of \$2,273,906 and \$71,914 were realized on fixed maturity sales for the years ended December 31, 2008 and 2007, respectively. Proceeds from sales of equity securities were \$1,080,647 and \$978,000 in 2008 and 2007, respectively. Gross gains of \$61,020 and \$5,600 were realized on the sale of equity securities for the years ended December 31, 2008 and 2007, respectively, and gross losses of \$1,158,333 and \$22,000 were realized on equity security sales for the years ended December 31, 2008 and 2007, respectively.

**(3) 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 Reported at Fair Value in Financial Statements**

The fair value of a financial instrument is the estimated amount at which the instrument could be exchanged in an orderly transaction between knowledgeable, unrelated willing parties, i.e., not in a forced transaction. The estimated fair value of a financial instrument may differ from the amount that could be realized if the security was sold in an immediate sale, e.g., a forced transaction. Additionally, the valuation of fixed maturity investments is more subjective when markets are less liquid due to the lack of market based inputs, which may increase the potential that the estimated fair value (i.e., the carrying amount) of an investment is not reflective of the price at which an actual transaction would occur.

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

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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 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 December 31, 2008.

	Total	Level 1	Level 2	Level 3
Invested assets:				
Fixed maturities	\$59,701,247	9,111,579	50,589,668	--
Equity securities	995,722	71,622	924,100	--
Short-term investments	<u>15,963,120</u>	<u>15,963,120</u>	--	--
Total	<u>\$76,660,089</u>	<u>25,146,321</u>	<u>51,513,768</u>	<u>--</u>

**(4) Receivables**

A summary of receivables at December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Insurance premiums due from agents	\$380,293	743,082
Receivables under construction contracts:		
Amounts billed	219,685	902,075
Recoverable costs in excess of billings on uncompleted contracts	140,121	207,517
Billings in excess of costs on uncompleted contracts	(10,457)	--
Retainage, due on completion of contracts	<u>582,441</u>	<u>422,293</u>
Total receivables under construction contracts	931,790	1,531,885
Other	<u>82,563</u>	<u>20,003</u>
Total receivables	1,394,646	2,294,970
Less allowances for doubtful accounts	<u>(71,231)</u>	<u>(101,231)</u>
Total receivables, net	<u>\$1,323,415</u>	<u>2,193,739</u>

The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the owner. In management's opinion, the majority of contract retainage is expected to be collected in 2009.

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Recoverable costs in excess of billings on uncompleted contracts are comprised principally of revenue recognized on contracts for which billings had not been presented to the contract owners as of the balance sheet date. These amounts will be billed in accordance with the contract terms.

**(5) Property and Equipment**

A summary of property and equipment at December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Building	\$16,950,163	16,371,597
Land	800,000	800,000
Equipment and vehicles	868,206	1,200,321
Furniture and fixtures	<u>899,802</u>	<u>866,355</u>
	19,518,171	19,238,273
Less accumulated depreciation	<u>8,873,324</u>	<u>8,828,624</u>
	<u>\$10,644,847</u>	<u>10,409,649</u>

Useful lives for depreciation purposes are five years for equipment and vehicles, seven years for furniture and fixtures and forty years for the building. Depreciation expense in 2008 and 2007 was \$468,639 and \$430,826, respectively.

Future minimum rental income to be generated by leasing a portion of the building under non-cancelable operating leases as of December 31, 2008 are estimated to be \$570,876 for 2009, \$546,876 for 2010, \$546,876 for 2011, \$546,876 for 2012 and \$1,118,014 thereafter. Rental income earned in 2008 and 2007 was \$505,909 and \$438,047, respectively.

**(6) Reserves for Losses and Loss Adjustment Expenses**

The following table sets forth a reconciliation of beginning and ending reserves for unpaid losses and loss adjustment expenses for the periods indicated on a GAAP basis for the business of the Company.

	<u>2008</u>	<u>2007</u>
Balance at January 1	\$22,845,815	22,080,301
Less reinsurance recoverable	<u>3,298,783</u>	<u>2,954,488</u>
Net balance at January 1	19,547,032	19,125,813
Incurred related to:		
Current year	1,435,000	3,059,000
Prior years	<u>(1,121,661)</u>	<u>(1,027,172)</u>
Total incurred	313,339	2,031,828
Payments related to:		
Current year	118,000	33,000
Prior years	<u>208,710</u>	<u>1,577,609</u>
Total payments	326,710	1,610,609
Net balance at December 31	19,533,661	19,547,032
Plus reinsurance recoverable	<u>3,530,878</u>	<u>3,298,783</u>
Balance at December 31	<u>\$23,064,539</u>	<u>22,845,815</u>

The increase in reserves for unpaid losses and loss adjustment expenses in 2008 from 2007 primarily resulted from a decrease in claim payments due to a decrease in claim activity. The reduction in prior year incurreds for 2008 represents favorable loss development on general liability and surety exposures. The decrease in reserves for unpaid losses and loss adjustment expenses in 2007 from 2006 primarily resulted from favorable claim settlement and reduced incurred losses and loss adjustment expenses. While management continually evaluates the potential for changes in loss estimates, due to the uncertainty inherent in the surety business, the emergence of net favorable development may or may not continue to occur. Management believes that the reserves for losses and loss adjustment expense are adequate to cover the unpaid portion of the ultimate net cost of losses and loss adjustment expenses, including losses incurred but not reported.

The Company has no exposure to any asbestos or environmental claims associated with general liability policies issued with the pre-1986 pollution exclusion. Policies written with the exclusion are typically associated with mass tort environmental and asbestos claims. The Company has never issued a policy with the pre-1986 pollution exclusion. The Company's exposure to asbestos and environmental

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liability claims is primarily limited to asbestos and environmental liability insurance for contractors and consultants involved in the remediation, removal, storage, treatment and/or disposal of environmental and asbestos hazards.

**(7) Notes Payable to Banks**

At December 31, 2008, the Company has a \$10,000,000 bank line of credit with a financial institution. The line of credit does not require the Company to maintain a compensating balance. There were no outstanding borrowings under this line of credit at December 31, 2008 and 2007. Under the terms of the line of credit, interest on the outstanding balance is calculated based upon the London Inter-Bank Offering Rate (LIBOR) plus 160 basis points in effect during the borrowing period. The Company pays an annual commitment fee of .25% of the unused portion of the bank line.

**(8) Long-term Debt**

A summary of long-term debt at December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Term Loan II due 2008	\$ --	1,000,000
Mortgage Note due 2009	92,983	1,051,122
Term Loan III due 2009	<u>5,944,444</u>	<u>6,611,110</u>
	<u>\$6,037,427</u>	<u>8,662,232</u>

On November 22, 2002, the Company obtained a \$10,000,000 term loan from two financial institutions, which is payable in monthly installments of \$55,556 with a balloon payment of \$5,388,888 due on November 22, 2009. The term loan has a balance of \$5,944,444 at December 31, 2008. The interest rate for this term loan varies based on LIBOR plus 200 basis points in effect during the borrowing period. In connection with this term loan, the Company also entered into an interest rate swap that establishes a fixed interest rate for half of the loaned amount at 6.08%. The loan agreement contains certain limitations on borrowing, minimum statutory capital levels and requires maintenance of certain ratios. The Company was in compliance with these covenants at December 31, 2008.

On December 23, 1998, the Company obtained a permanent mortgage loan from a financial institution. The \$7,800,000 mortgage note, with interest fixed at 6.95% is payable in monthly installments of principal and interest over 10 years. The mortgage note, due 2009, has a balance of \$92,983 at December 31, 2008. The loan agreements contain certain limitations on borrowings, minimum statutory capital levels and require maintenance of certain ratios. The Company was in compliance with these covenants at December 31, 2008.

In December, 2008, the Company's \$5,000,000 Term Loan II matured and was fully paid.

Principal payments on long-term debt are \$6,037,427 for the year 2009. Interest expense paid in 2008 and 2007 amounted to \$454,657 and \$731,384, respectively.

The fair value at December 31, 2008 of the term loan approximates carrying value.

**(9) Income Taxes**

The components of income tax expense for the years ended December 31, 2008 and 2007 were as follows:

	<u>2008</u>	<u>2007</u>
Current Taxes:		
Federal	\$ 806,227	1,688,024
State	<u>140,000</u>	<u>200,000</u>
	<u>946,227</u>	<u>1,888,024</u>
Deferred Taxes:		
Federal	123,662	115,773
State	---	--
	<u>123,662</u>	<u>115,773</u>
Total	<u>\$1,069,889</u>	<u>2,003,797</u>

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The effective income tax rate, as a percentage of earnings before income taxes for the years ended December 31, 2008 and 2007 was as follows:

	<u>2008</u>	<u>2007</u>
Federal statutory tax rate	34.0%	34.0%
State income tax	3.1	2.2
Prior year effect	--	(2.6)
Other, net	<u>(1.7)</u>	<u>(.9)</u>
Effective income tax rate	<u>35.4%</u>	<u>32.7%</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are presented below:

	<u>2008</u>	<u>2007</u>
Deferred Tax Assets:		
Reserves for losses and loss adjustment expenses	\$ 545,779	629,694
Unearned premiums	176,399	208,524
Allowance for doubtful accounts	24,218	34,418
State effect of temporary differences and net operating loss carryforward	1,056,129	852,261
Unrealized losses in investments	684,641	678,540
Stock based compensation	<u>128,101</u>	<u>104,144</u>
Total gross deferred tax assets	2,615,267	2,507,581
Less valuation allowance	<u>(1740,770)</u>	<u>(1,530,801)</u>
Net deferred tax assets	\$ 874,497	976,780
Deferred Tax Liabilities:		
Plant and equipment	\$ 645,401	580,828
Deferred policy acquisition costs	319,838	343,782
Discount on investments	143,966	163,216
Other	<u>179</u>	<u>179</u>
Total gross deferred tax liabilities	<u>1,109,384</u>	<u>1,088,005</u>
Net deferred tax assets (liabilities)	\$ <u>(234,887)</u>	<u>(111,225)</u>

In assessing the realization of deferred tax assets, management considers whether it is more likely than not that the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, tax planning strategies and anticipated future taxable income in making this assessment and believes it is more likely than not the Company will realize the benefits of its deductible temporary differences, net of the valuation allowance, at December 31, 2008 and 2007.

The most significant component of the state gross deferred asset is the net operating loss carryforward for the State of Connecticut which amounted to \$21,122,589 as of December 31, 2008 which expires in 2020 through 2027. In 2008 and 2007, a valuation allowance is provided to offset the deferred tax asset related to the state deferred tax assets as management believes that these deferred tax assets are unrealizable. In addition there is a valuation allowance for unrealized losses on investments. The change of \$209,969 in the valuation allowance is due to the current tax loss generated by the Connecticut domiciled companies as well as decreases in unrealized losses in the investment portfolio.

Taxes paid in 2008 and 2007 were \$1,501,225 and \$2,418,653, respectively.

**(10) Pension and Profit Sharing Plans**

The Company maintains ACMAT 401(k) plan for the benefit of non-union employees. The Company contributed \$100,000 to the ACMAT 401(k) Plan in 2008 and 2007. Costs associated with operating the Plan are borne by the Company and were insignificant for each of the years ended December 31, 2008 and 2007.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(11) Derivative Financial Instruments**

The Company uses interest rate swaps as a means of hedging exposure to interest rate risk on its long-term debt. To qualify as a hedge, the hedge relationship must be designated and documented at inception and be highly effective in accomplishing the objective of offsetting the changes in cash flows for the risk being hedged. To the extent these derivatives are effective in offsetting the variability of the hedged cash flows, changes in the derivatives' fair value are not to be included in current earnings but are reported in accumulated other comprehensive income ("AOCI"). For the years ended December 31, 2008 and 2007, the amounts included in AOCI for these changes were losses of \$64,703 in 2008 and \$101,921 in 2007 and would be included in the earnings of future periods when those earnings are also affected by the variability of the hedged cash flows.

During the year ending December 31, 2009, the amount of losses the Company expects to reclassify from AOCI into interest expense for its cash flow hedges is not significant. To the extent these hedges are not effective, changes in their fair value would be immediately included in earnings.

**(12) Stockholders' Equity**

The Company has two classes of common stock; the Common Stock and the Class A Stock, each without par value. The rights of the Common Stock and the Class A Stock are identical, except with respect to voting rights. Holders of the Class A Stock are entitled to one-tenth vote per share in relation to the Common Stock, holders of which are entitled to one vote per share.

During 2008 and 2007, ACMAT repurchased and retired, in the open market and in privately negotiated transactions, 7,086 and 2,893, respectively, shares of its Common Stock at an average price of \$26.83 and \$24.54 per share, respectively. The Company also repurchased and retired during 2008 and 2007, in the open market and in privately negotiated transactions, 246,267 and 125,313, respectively, shares of its Class A Stock at an average price of \$26.60 and \$26.25 per share, respectively.

Under applicable insurance regulations, ACMAT's insurance subsidiary is restricted as to the amount of dividends it may pay, without the prior approval of any insurance department and is limited to \$3,735,814 in 2009.

The Company's insurance subsidiary ACSTAR, is domiciled in Illinois. The statutory financial statements of ACSTAR are prepared in accordance with accounting practices prescribed by the Illinois Department of Insurance. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as the state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed of which the Company has none.

In accordance with statutory accounting practices, ACMAT's insurance subsidiaries' statutory capital and surplus was \$30,841,403 and \$31,609,906 at December 31, 2008 and 2007 respectively, and their statutory net income for the years ended December 31, 2008 and 2007 was \$3,735,814 and \$5,241,538, respectively. The primary differences between amounts reported in accordance with GAAP and amounts reported in accordance with statutory accounting practices are carrying value of fixed maturity investments; deferred taxes; assets not admitted for statutory purposes such as agents balances over 90 days, furniture and fixtures and certain notes receivable; and deferred acquisition costs recognized for GAAP only.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(13) Earnings Per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share (“EPS”) computations for the years ended December 31, 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	\$1,954,459	1,643,175	\$1.19
Effect of Dilutive Securities:			
Stock options	<u>---</u>	<u>127,390</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$1,954,459</u>	<u>1,770,565</u>	<u>\$1.10</u>
<u>2007:</u>			
Basic EPS:			
Earnings available to stockholders	\$4,116,497	1,859,820	\$2.21
Effect of Dilutive Securities:			
Stock options	<u>--</u>	<u>137,400</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$4,116,497</u>	<u>1,997,220</u>	<u>\$2.06</u>

**(14) Stock – Based Compensation**

The Company periodically grants non-qualified stock options to officers and directors 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.

The Company applied the recognition and measurement principles of SFAS 123R, Share Based Payments, beginning January 1, 2006. The weighted average fair value of the outstanding options was \$10.71 for the year ended December 31, 2008. Total stock-based compensation expense totaled \$70,461 and \$117,420 for the year ended December 31, 2008 and 2007, respectively. The tax benefit recognized on stock-based compensation totaled \$23,957 and \$39,923 for the year ended December 31, 2008 and 2007, respectively.

As of December 31, 2008 there were 339,500 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 \$58,000 as of December 31, 2008. The Company expects to recognize that cost over a weighted average period of 2.0 years.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following table shows the stock option activity for the Company during 2008 and 2007.

	Option Shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2006	378,000	\$10.60		
2007 activity:				
Granted	--			
Exercised	(19,000)	\$ 9.60		
Canceled	<u>--</u>			
Outstanding at December 31, 2007	<u>359,000</u>	\$10.65		
2008 activity:				
Granted	--			
Exercised	(19,500)	\$ 9.57		
Canceled	<u>--</u>			
Outstanding at December 31, 2008	<u>339,500</u>	\$10.71	4.57	\$1,665,927
Exercisable at December 31, 2008	<u>276,833</u>	\$10.78	4.59	\$1,358,420
Expected to Vest	<u>62,667</u>	\$10.40	4.46	\$ 307,507

Of the 359,000 outstanding options at December 31, 2007, 261,600 were exercisable. During 2008 and 2007, officers and directors exercised 19,500 and 19,000 stock options, respectively. Proceeds from stock options exercised in 2008 and 2007 were \$186,700 and \$182,480, respectively. Tax benefits related to stock options exercised in 2008 and 2007 were \$108,902 and \$109,997, respectively.

The following table summarizes information about stock options outstanding at December 31, 2008:

Range of exercise price	Number Outstanding	Weighted average remaining contractual life	Weighted average exercise price	Grant Year	Number exercisable
\$ 7.25	20,000	1.95	\$ 7.25	2000	20,000
\$ 9.00	151,000	3.47	\$ 9.00	2002	109,000
\$12.22	61,500	5.20	\$12.22	2004	61,500
\$11.40	20,000	5.20	\$11.40	2004	20,000
\$13.25	<u>87,000</u>	6.48	\$13.25	2005	<u>66,333</u>
\$7.25-13.25	<u>339,500</u>	4.57	\$10.71		<u>276,833</u>

**(15) Commitments and Contingencies**

The Company is a party to legal actions arising in the ordinary course of its business. In management's opinion, the Company has adequate legal defenses respecting those actions where the Company is a defendant, has appropriate insurance reserves recorded, and does not believe that their settlement will materially affect the Company's operations or financial position.

Many construction projects in which the Company had been engaged included asbestos exposures which the Company believes to involve a particularly high degree of risk because of the hazardous nature of asbestos. The Company believes it reduced the risks associated with asbestos through proper training of its employees and by maintaining general liability and workers' compensation insurance. From 1986 to 1996, the Company obtained its general liability insurance from its insurance subsidiaries. Since 1996, the Company obtained its general liability insurance from unaffiliated insurance companies. Since 1989, the Company has obtained its surety bonds from its insurance subsidiary.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Since 1995, the Company has, together with many other defendants, been named as a defendant in actions by injured or deceased individuals or their representatives based on product liability or negligence claims relating to materials containing asbestos. No specific claims for monetary damages are asserted in these actions. Many of these actions have been dismissed or settled for nominal payments by the Company or its insurers. At this time, the Company does not believe that its exposure in connection with these cases is significant.

**(16) 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 insurance.

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.

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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 is summarized as follows:

	<u>2008</u>	<u>2007</u>
Revenues:		
ACSTAR Bonding	\$ 9,570,058	14,203,769
ACMAT Contracting	<u>6,386,958</u>	<u>9,030,286</u>
	<u>\$15,957,016</u>	<u>23,234,055</u>
Operating Earnings (Loss):		
ACSTAR Bonding	\$5,380,366	7,608,216
ACMAT Contracting	<u>(1,906,465)</u>	<u>(762,437)</u>
	<u>\$3,473,901</u>	<u>6,845,779</u>
Depreciation and Amortization:		
ACSTAR Bonding	\$(60,699)	(192,569)
ACMAT Contracting	<u>456,444</u>	<u>445,785</u>
	<u>\$395,745</u>	<u>253,216</u>
Identifiable Assets:		
ACSTAR Bonding	\$ 90,303,757	94,782,182
ACMAT Contracting	<u>19,960,298</u>	<u>26,991,056</u>
	<u>\$110,264,055</u>	<u>121,773,238</u>
Capital Expenditures:		
ACSTAR Bonding	\$109,819	27,145
ACMAT Contracting	<u>594,018</u>	<u>140,813</u>
	<u>\$703,837</u>	<u>167,958</u>

The components of revenue for each segment are as follows:

	<u>2008</u>	<u>2007</u>
ACSTAR Bonding:		
Premiums	\$7,590,974	10,159,139
Investment income, net	3,161,487	4,231,443
Capital losses	(1,363,808)	(76,808)
Other income (expense)	<u>181,405</u>	<u>(110,005)</u>
	<u>\$9,570,058</u>	<u>14,203,769</u>
ACMAT Contracting:		
Contract revenues	\$4,590,997	5,676,191
Investment income, net	422,571	701,989
Capital losses	(647,688)	(2,773)
Inter-segment revenue:		
Rental income	316,598	366,961
Underwriting services and agency commissions	1,240,161	1,809,779
Other income	<u>464,319</u>	<u>478,139</u>
	<u>\$6,386,958</u>	<u>9,030,286</u>

**ACMAT CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

Revenue:	<u>2008</u>	<u>2007</u>
Total revenue for reportable segments	\$15,957,016	23,234,055
Inter-segment eliminations	<u>(1,001,539)</u>	<u>(1,276,789)</u>
	<u>\$14,955,477</u>	<u>21,957,266</u>
Operating Earnings:		
Total operating earnings for reportable segments	\$3,473,901	6,845,779
Interest expense	<u>(449,553)</u>	<u>(725,485)</u>
	<u>\$3,024,348</u>	<u>6,120,294</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 selling, general and administrative expenses. 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.

## **INDEPENDENT AUDITORS' REPORT**

The Board of Directors  
ACMAT Corporation:

We have audited the consolidated balance sheets of ACMAT Corporation and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of earnings, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ACMAT Corporation and its subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Hartford, Connecticut  
April 23, 2009

## Our Services

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### **Stock Market Information**

The Company's Common Stock and Class A Stock trade over-the-counter in the "Pink Sheets" quotation service. The following table sets forth the quarterly high and low closing prices of the Company's Common Stock and Class A Stock.

	<u>2008</u>		<u>2007</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
<b>Common Stock</b>				
1st Quarter	27.00	27.00	35.00	23.50
2nd Quarter	27.00	27.00	26.00	24.10
3rd Quarter	27.00	27.00	27.00	26.00
4th Quarter	27.00	23.00	27.00	27.00
<b>Class A Stock</b>				
1st Quarter	29.60	22.00	27.80	23.50
2nd Quarter	28.50	24.00	28.00	24.25
3rd Quarter	28.00	24.15	26.00	24.80
4th Quarter	33.00	15.76	26.30	23.00

### **Annual Meeting**

The annual meeting of stockholders will be held on June 18, 2009 at 12:00 P.M on the third floor of the Company's corporate headquarters. All holders of ACMAT Common Stock and Class A Stock at the close of business on the record date of April 17, 2009 are entitled to vote.

### **Dividends**

No cash dividends have been paid in the past five years and there is no intention of paying dividends in the near future.

### **Transfer Agent**

American Stock Transfer & Trust Company  
59 Maiden Lane  
New York, NY 10007  
(718)-921-8200

## Directors

**Henry W. Nozko, Jr.**  
Chairman, President &  
Chief Executive Officer

**Henry W. Nozko III**  
Vice President, Secretary

**Victoria C. Nozko**

**John C. Creasy**  
Former Chief Executive Officer  
Danbury Hospital

**Arthur R. Moore**  
Former General President  
Sheet Metal Workers' International Association

**Andrew M. Sullivan, Jr.**  
Retired Partner of KPMG LLP

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## Officers

**Henry W. Nozko, Jr.**  
Chairman, President &  
Chief Executive Officer

**Michael P. Cifone**  
Senior Vice President,  
Chief Financial Officer

**Henry W. Nozko III**  
Vice President, Secretary

**Gary M. Case, Esq.**  
General Counsel

**Robert H. Frazer, Esq.**  
Vice President,  
General Counsel Emeritus

**David A. Price**  
Vice President

## Managers

**Maurice C. Shea**  
Controller

**Ray A. Suite**  
Estimating Manager

**Project Managers**  
J. Marshall Reed  
J. Parris Reed

**Robert Winchell**  
Building Manager

## ACSTAR Insurance Company

**Henry W. Nozko, Jr.**  
Chairman, President &  
Chief Executive Officer

**Michael P. Cifone**  
Senior Vice President  
Chief Financial Officer

**Henry W. Nozko III**  
Vice President, Secretary

**Gary M. Case, Esq.**  
General Counsel

**Robert H. Frazer, Esq.**  
Vice President,  
General Counsel Emeritus

**David A. Price**  
Vice President

**Joan C. Fortier**  
Assistant Vice President

**Dennis E. Kane**  
Controller

**Underwriting Managers**  
Carmen Carlton  
Susan Deriso, CPCU, AFSB