

ACMAT CORPORATION AND SUBSIDIARIES
DECEMBER 31, 2006

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ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Earnings Years Ended December 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Earned premiums	\$12,437,099	12,980,022
Contract revenues	6,086,702	5,527,900
Investment income, net	5,140,425	4,282,155
Sale of subsidiary	--	7,336,667
Net realized capital losses	(210,947)	(472,403)
Other income	<u>746,052</u>	<u>885,358</u>
	24,199,331	30,539,699
Cost of contract revenues	5,937,573	5,303,809
Losses and loss adjustment expenses	2,413,289	3,965,966
Amortization of policy acquisition costs	2,721,398	2,646,600
General and administrative expenses	4,662,019	4,821,818
Interest expense	<u>891,568</u>	<u>919,767</u>
	16,625,847	17,657,960
Earnings before income taxes	7,573,484	12,881,739
Income taxes	<u>2,574,165</u>	<u>4,398,017</u>
Net earnings	<u>\$4,999,319</u>	<u>8,483,722</u>
Basic earnings per share	<u>\$2.43</u>	<u>3.77</u>
Diluted earnings per share	<u>\$2.30</u>	<u>3.66</u>

See Notes to Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets
December 31, 2006 and 2005

<u>Assets</u>	<u>2006</u>	<u>2005</u>
Investments:		
Fixed maturities – available for sale at fair value (Amortized cost of \$56,591,385 in 2006 and \$80,003,030 in 2005)	\$ 56,300,695	79,436,415
Equity securities – available for sale at fair value (Cost of \$14,763,359 in 2006 and \$10,074,759 in 2005)	15,140,013	10,086,263
Short-term investments, at cost which approximates fair value	<u>29,972,891</u>	<u>9,281,841</u>
Total Investments	101,413,599	98,804,519
Cash and cash equivalents	7,584,783	14,729,289
Accrued interest receivable	270,410	514,629
Receivables, net of allowance for doubtful accounts of \$101,231 in 2006 and \$302,606 in 2005	892,046	1,718,382
Reinsurance recoverable:		
Unpaid losses	2,954,488	3,896,869
Paid losses	43,392	164,118
Prepaid expenses	203,487	171,559
Deferred income taxes	--	370,888
Property and equipment, net	10,672,517	10,874,334
Deferred policy acquisition costs	1,201,221	1,219,209
Other assets	1,837,031	1,294,130
Intangibles	<u>1,920,360</u>	<u>1,920,360</u>
Total Assets	<u>\$128,993,334</u>	<u>135,678,286</u>
<u>Liabilities & Stockholders' Equity</u>		
Accounts payable	\$1,538,035	2,861,329
Reserves for losses and loss adjustment expenses	22,080,301	23,102,777
Unearned premiums	4,636,637	4,998,721
Collateral held	36,547,528	36,508,599
Income tax payable	299,762	282,595
Deferred income taxes	24,677	--
Other accrued liabilities	2,573,272	3,051,273
Long-term debt	<u>11,306,288</u>	<u>13,883,988</u>
Total Liabilities	79,006,500	84,689,282
Stockholders' Equity:		
Common Stock (No par value; 3,500,000 shares authorized; 481,585 and 510,585 shares issued and outstanding)	481,585	510,585
Class A Stock (No par value; 10,000,000 shares authorized; 1,422,273 and 1,699,848 shares issued and outstanding)	1,422,273	1,699,848
Retained earnings	47,913,873	49,220,834
Accumulated other comprehensive income (loss)	169,103	(442,263)
Total Stockholders' Equity	<u>49,986,834</u>	<u>50,989,004</u>
	<u>\$128,993,334</u>	<u>135,678,286</u>

See Notes to Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity
December 31, 2006 and 2005

	<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, 2004	\$540,329	1,738,478	41,676,900	108,002	44,063,709
Comprehensive income:					
Net unrealized loss on debt and equity securities, net of reclassification adjustment	---	---	---	(428,520)	(428,520)
Net unrealized loss on derivatives qualifying as hedges	---	---	---	(121,745)	(121,745)
Net earnings	---	---	8,483,722	---	<u>8,483,722</u>
Total comprehensive income					7,933,457
Acquisition and retirement of 29,744 shares of Common Stock	(29,744)	---	(445,849)	---	(475,593)
Acquisition and retirement of 46,130 shares of Class A Stock	---	(46,130)	(567,072)	---	(613,202)
Issuance of 7,500 shares of Class A Stock pursuant to stock options	---	<u>7,500</u>	<u>73,133</u>	---	<u>80,633</u>
Balance as of December 31, 2005	<u>\$510,585</u>	<u>1,699,848</u>	<u>49,220,834</u>	<u>(442,263)</u>	<u>50,989,004</u>
Comprehensive income:					
Net unrealized gain on debt and equity securities, net of reclassification adjustment	---	---	---	611,836	611,836
Net unrealized loss on derivatives qualifying as hedges	---	---	---	(470)	(470)
Net earnings	---	---	4,999,319	---	<u>4,999,319</u>
Total comprehensive income					5,610,685
Stock based compensation	---	---	188,886	---	188,886
Acquisition and retirement of 29,000 shares of Common Stock	(29,000)	---	(658,100)	---	(687,100)
Acquisition and retirement of 308,575 shares of Class A Stock	---	(308,575)	(6,179,170)	---	(6,487,745)
Issuance of 31,000 shares of Class A Stock pursuant to stock options	---	<u>31,000</u>	<u>342,104</u>	---	<u>373,104</u>
Balance as of December 31, 2006	<u><u>481,585</u></u>	<u><u>1,422,273</u></u>	<u><u>47,913,873</u></u>	<u><u>169,103</u></u>	<u><u>49,986,834</u></u>

See Notes to Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows
Years ended December 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash Flows From Operating Activities:		
Net earnings	\$4,999,319	8,483,722
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Sale of subsidiary	--	(7,336,667)
Stock based compensation expense	188,886	--
Depreciation and amortization	382,946	543,242
Net realized capital losses	210,947	472,403
Deferred income taxes	366,340	1,709,085
Changes In:		
Accrued interest receivable	244,219	(51,037)
Receivables, net	826,336	995,222
Reinsurance recoverable	1,063,107	316,646
Deferred policy acquisition costs	17,988	430,489
Prepaid expenses and other assets	(574,8290)	4,010,112
Accounts payable and other liabilities	(1,800,825)	1,174,535
Collateral held	38,929	(7,853,391)
Reserves for losses and loss adjustment expenses	(1,022,476)	(67,194)
Income taxes	16,222	209,373
Other	--	14,216
Unearned premiums	<u>(362,084)</u>	<u>(1,843,245)</u>
Net cash provided by operating activities	<u>4,595,025</u>	<u>1,207,511</u>
Cash Flows From Investing Activities:		
Proceeds from investments sold or matured:		
Fixed maturities – sold	36,746,743	26,103,229
Fixed maturities – matured	11,545,000	10,900,441
Equity securities	2,478,985	5,492,397
Purchases Of:		
Fixed maturities	(25,000,906)	(61,701,247)
Equity securities	(7,200,000)	(5,494,200)
Short-term investments, (purchases) sales, net	(20,691,050)	6,080,274
Sale of subsidiary	--	7,336,667
Capital expenditures	<u>(238,862)</u>	<u>(433,136)</u>
Net cash used for investing activities	<u>(2,360,090)</u>	<u>(11,715,575)</u>
Cash Flows From Financing Activities:		
Repayments on long-term debt	(2,577,700)	(2,515,891)
Issuance of Common and Class A Stock	254,750	67,500
Tax benefit from exercise of stock options	118,354	--
Payments for acquisition and retirement of stock	<u>(7,174,845)</u>	<u>(1,088,795)</u>
Net cash used for financing activities	<u>(9,379,441)</u>	<u>(3,537,186)</u>
Net change in cash and cash equivalents	(7,144,506)	(14,045,250)
Cash and cash equivalents, beginning of year	<u>14,729,289</u>	<u>28,774,539</u>
Cash and cash equivalents, end of year	<u>\$ 7,584,783</u>	<u>14,729,289</u>

See Notes to Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006 and 2005

(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"). On November 22, 2005, United Coastal Insurance Company ("United Coastal") was sold.

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.

On November 22, 2005, the Company and ACSTAR completed the sale of their shares of United Coastal to Rockhill Holding Company. United Coastal was wholly-owned by ACMAT and ACSTAR. The purchase price of approximately \$30 million was based upon United Coastal's net assets valued at market plus a premium for United Coastal's insurance authorizations. The transaction resulted in a one-time pre-tax increase in ACMAT's revenues and earnings of approximately \$7.3 million.

The United Coastal Liability Insurance operating segment offered specific lines of liability insurance as an approved non-admitted excess and surplus lines insurer in forty-seven states, Puerto Rico, the Virgin Islands and the District of Columbia. United Coastal offered claims made and occurrence policies for specific specialty lines of liability insurance through certain excess and surplus lines brokers who are licensed and regulated by the state insurance department(s) in the state(s) in which they operate. United Coastal provided specialty general, environmental and professional liability insurance primarily to general contractors, specialty trade and environmental contractors, property owners, as well as architects, consultants and engineers. United Coastal also offered products liability policies to manufacturers and others.

Effective March 3, 2005, the Company effectively terminated the registration of its Common Stock and its Class A Common Stock under the Securities Exchange Act of 1934. As a result of these filings, the Company's obligation to file with the Securities and Exchange Commission certain reports and forms, including Forms 10-K, 10-Q and 8-K, has been suspended. The Company's Common Stock and Class A Common Stock now trades over-the-counter in the "Pink Sheets" quotation service.

During 2006 and 2005, customers who individually accounted for more than 10% of consolidated construction contracting revenue are as follows; in 2006 - four customers provided 33%, 31%, 19% and 17%, respectively and in 2005 - two customers provided 45%, and 19%, 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.

ACMAT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

Short-term investments, consisting primarily of money market instruments 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.

(d) Deferred Policy Acquisition Costs

Deferred policy acquisition costs, representing commissions and certain pre-tax 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 recoverable 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.

(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.

ACMAT CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(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 \$6,000,000 on a per principal basis. The Company also cedes 10% of each and every \$1,000,000 policy and cedes 80% of \$2,000,000 in excess of \$1,000,000.

Reinsurance recoverables include ceded reserves for losses and loss adjustment expenses. Ceded unearned premiums of \$643,375 and \$739,135 at December 31, 2006 and 2005, 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>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Direct	\$14,318,226	13,188,776	\$13,814,741	15,199,407
Assumed	(14,379)	415,687	851,189	332,500
Ceded	<u>(2,133,071)</u>	<u>(2,138,272)</u>	<u>(2,228,831)</u>	<u>(2,551,885)</u>
Totals	<u>\$12,170,776</u>	<u>11,466,191</u>	<u>\$12,437,099</u>	<u>12,980,022</u>

Ceded incurred losses and loss adjustment expenses totaled \$432,481 and \$779,713 for the years ended December 31, 2006 and 2005, 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.

(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.

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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 U.S. Generally Accepted Accounting Principles 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, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Unrealized holding gain (loss) arising during period, net of income tax expense of \$29,225 in 2006 and \$0 in 2005	\$472,611	(740,306)
Less reclassification adjustment for losses included in net earnings, net of income tax benefit of \$71,722 in 2006 and \$160,617 in 2005	(139,225)	(311,786)
Unrealized loss on derivatives qualifying as cash flow hedges	<u>(470)</u>	<u>(121,745)</u>
Other comprehensive income (loss)	<u>\$611,366</u>	<u>(550,265)</u>

(o) Stock – Based Compensation

In December 2004, the FASB issued Revised Statement of Financial Standards No. 123, “Share-Based Payment (FAS 123R), an amendment to FAS 123 and a replacement of Accounting Principles Board Opinion No. 25 (APB 25), “Accounting for Stock Issued to Employees”, and related implementation guidance. FAS 123R requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award, and to recognize that cost over the requisite service period.

The Company adopted FAS 123R using the modified prospective method. Under the modified prospective application, compensation costs in 2006 includes costs for stock options granted prior to but not vested as of December 31, 2005 and options vested in 2006. The impact of adopting the modified prospective application of FAS 123R lowered income before tax expense by \$188,886 for the year ended December 31, 2006 compared to if the Company had continued to account for stock-based compensation under APB 25. Refer to Note 14.

(p) Recent Accounting Pronouncements

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.

SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. The adoption of SOP 05-1 effective January 1, 2007 did not have a material effect on operations, financial condition or liquidity.

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The FSP addresses the determination as to when an investment is considered

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impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. It requires the establishment of a new cost basis subsequent to the recognition of an other-than-temporary impairment and certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The FSP is effective for reporting periods beginning after December 15, 2005. The adoption of the FSP did not have a material effect on the Company's results of 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.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 effective January 1, 2007 did not have a material effect on the Company's results of operations, financial condition 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. The Company does not expect the provisions of FAS 157 to have a material effect on its results of operations, financial condition or liquidity.

Accounting Changes and Error Corrections

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (FAS 154), which replaced APB Opinion No. 20 *Accounting Changes*, and FASB Statement of Financial Accounting Standards No. 3, *Reporting Changes in Interim Financial Statements*. FAS 154 changed the requirements for the accounting for and reporting of a change in accounting principle. It requires retrospective application to prior period financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. FAS 154 was effective for accounting changes and corrections of errors in fiscal years beginning after December 15, 2005. Early adoption was permitted for accounting changes and corrections of errors made in fiscal years beginning after June 1, 2005. It did not change the transition provisions of any existing accounting pronouncements, including those that were in a transition phase as of December 15, 2005. The adoption of FAS 154 at January 1, 2006 had no effect on the Company's results of operations, financial condition or liquidity.

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(2) Investments

Investments at December 31, 2006 and 2005 follows:

2006

Fixed maturities – available for sale:

Bonds:

States, municipalities and political subdivisions
 United States government and government agencies
 Mortgage-backed securities
 Industrial and miscellaneous

AMORTIZED
 COST

ESTIMATED
 FAIR VALUE

\$ 743,676
 10,281,601
 41,566,108
4,000,000
 56,591,385

729,561
 10,184,110
 41,473,679
3,913,345
 56,300,695

Total fixed maturities

Equity securities – common stocks:

Banks, trusts and insurance

80,559
 197,293

Equity securities – redeemable preferred stocks:

Banks, trusts and insurance

2,250,000
 2,265,800

Public utilities

500,000
 504,200

Industrial and miscellaneous

7,150,000
 7,227,020

Equity securities perpetual preferreds:

Banks, trusts and insurance

550,000
 585,200

Industrial and miscellaneous

4,232,800
4,360,500

Total equity securities

14,763,359
 15,140,013

Short-term investments

29,972,891
29,972,891

Total investments

\$101,327,635

101,413,599

AMORTIZED
 COST

ESTIMATED
 FAIR VALUE

2005

Fixed maturities – available for sale:

Bonds:

States, municipalities and political subdivisions
 United States government and government agencies
 Mortgage-backed securities
 Industrial and miscellaneous

\$ 1,749,119
 10,770,984
 51,895,478
15,587,449
 80,003,030

1,735,004
 10,596,625
 51,870,271
15,234,515
 79,436,415

Total fixed maturities

Equity securities – common stocks:

Banks, trusts and insurance

80,559
 183,463

Equity securities – redeemable preferred stocks:

Banks, trusts and insurance

1,511,400
 1,498,400

Public utilities

500,000
 505,200

Industrial and miscellaneous

4,000,000
 3,887,200

Equity securities perpetual preferreds:

Industrial and miscellaneous

3,982,800
4,012,000

Total equity securities

10,074,759
 10,086,263

Short-term investments

9,281,841
9,281,841

Total investments

\$99,359,630

98,804,519

On December 31, 2006 and 2005, the Company's insurance subsidiary had securities with an aggregate fair value of approximately \$4 million on deposit with various state regulatory authorities.

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The amortized cost and fair value of fixed maturities at December 31, 2006, by effective maturity, follows:

	<u>2006</u>	
	<u>Amortized</u> <u>Cost</u>	<u>Fair</u> <u>Value</u>
Due in one year or less	\$ 3,717,027	3,681,468
Due after one year through five years	6,839,652	6,797,224
Due after five years through ten years	2,743,676	2,691,501
Due after ten years	1,724,922	1,656,823
Mortgage-backed securities	<u>41,566,108</u>	<u>41,473,679</u>
Total	<u>\$56,591,385</u>	<u>56,300,695</u>

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 collateralized mortgage obligations (CMOs). CMOs typically have high credit quality, offer good liquidity, and provide a significant advantage in yield and total return 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. This drives the investment process to generally favor prepayment protected CMO tranches including planned amortization classes and last cash flow tranches. 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, 2006 and 2005, the Company held CMOs classified as available for sale with a fair value of \$41,363,934 and \$47,725,748 respectively. Approximately 83% and 92% of the Company's CMO holdings are fully collateralized by GNMA, FNMA or FHLMC securities at December 31, 2006 and 2005, respectively. In addition, the Company held \$109,745 and \$206,864 of FNMA mortgage-backed pass-through securities classified as available for sale at December 31, 2006 and 2005, respectively. Virtually all of these securities are rated Aaa.

A summary of gross unrealized gains and losses at December 31, 2006 and 2005 follows:

	<u>2006</u>		<u>2005</u>	
	<u>Gains</u>	<u>Losses</u>	<u>Gains</u>	<u>Losses</u>
States, municipalities and Political subdivisions	\$ --	(14,115)	---	(14,115)
United States government and Government agencies	2,944	(100,435)	4,563	(178,922)
Industrial and miscellaneous	--	(86,655)	2,227	(355,161)
Mortgage-backed securities	<u>170,382</u>	<u>(262,811)</u>	<u>168,761</u>	<u>(193,968)</u>
Total	173,326	(464,016)	175,551	(742,166)
Equity securities	<u>409,514</u>	<u>(32,860)</u>	<u>183,504</u>	<u>(172,000)</u>
Total	<u>\$582,840</u>	<u>(496,876)</u>	<u>359,055</u>	<u>(914,166)</u>

An investment in a debt or equity security is 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. Additionally, for certain securitized financial assets with contractual cash flows (including asset backed securities), EITF 99-20 requires the Company to periodically update its best estimate of cash flows over the life of the security. 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

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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.

The gross unrealized investment losses and related fair value for fixed maturities and equity securities at December 31, 2006 and 2005 were as follows:

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total 2006</u>	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Fixed maturities:						
States, municipalities and political subdivisions	--	--	729,561	14,115	729,561	14,115
United States government and government agencies	5,439,459	23,841	4,140,433	76,594	9,579,892	100,435
Mortgage-backed securities	2,045,155	10,090	22,230,571	252,721	24,275,726	262,811
Industrial and miscellaneous	<u>1,466,900</u>	<u>33,100</u>	<u>2,446,445</u>	<u>53,555</u>	<u>3,913,345</u>	<u>86,655</u>
Total fixed maturities	8,951,514	67,031	29,547,010	396,985	38,498,524	464,016
Equity securities – common stocks	--	--	--	--	--	--
Equity securities – redeemable preferred	733,140	16,860	1,484,000	16,000	2,217,140	32,860
Equity securities – perpetual preferred	--	--	--	--	--	--
Total equity	<u>733,140</u>	<u>16,860</u>	<u>1,484,000</u>	<u>16,000</u>	<u>2,217,140</u>	<u>32,860</u>
Total temporarily impaired securities	<u>9,684,654</u>	<u>83,891</u>	<u>31,031,010</u>	<u>412,895</u>	<u>40,715,664</u>	<u>496,876</u>
	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total 2005</u>	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Fixed maturities:						
States, municipalities and political subdivisions	\$ 208,389	1,194	526,615	12,921	735,004	14,115
United States government and government agencies	6,366,036	108,957	2,525,812	69,965	8,891,848	178,922
Mortgage-backed securities	26,548,908	155,115	3,148,008	38,853	29,696,916	193,968
Industrial and miscellaneous	<u>6,018,710</u>	<u>60,527</u>	<u>4,713,115</u>	<u>294,634</u>	<u>10,731,825</u>	<u>355,161</u>
Total fixed maturities	39,142,043	325,793	10,913,550	416,373	50,055,593	742,166
Equity securities – common stocks	---	---	---	---	---	---
Equity securities – redeemable preferred	1,498,400	13,000	2,365,000	135,000	3,863,400	148,000
Equity securities – perpetual preferred	---	---	<u>976,000</u>	<u>24,000</u>	<u>976,000</u>	<u>24,000</u>
Total equity	<u>1,498,400</u>	<u>13,000</u>	<u>3,341,000</u>	<u>159,000</u>	<u>4,839,400</u>	<u>172,000</u>
Total temporarily impaired securities	<u>\$40,640,443</u>	<u>338,793</u>	<u>14,254,550</u>	<u>575,373</u>	<u>54,894,993</u>	<u>914,166</u>

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(3) Investment Income and Realized Capital Gains and Losses

A summary of net investment income for the years ended December 31, 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
Tax-exempt interest	\$ 26,444	20,846
Taxable interest	4,456,801	3,545,297
Dividends on equity securities	710,674	760,288
Investment expenses	<u>(53,494)</u>	<u>(44,276)</u>
Net investment income	<u>\$5,140,425</u>	<u>4,282,155</u>

Net realized capital losses for the years ended December 31, 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
Fixed maturities	\$(178,532)	(342,546)
Equity securities	<u>(32,415)</u>	<u>(129,857)</u>
Net realized capital losses	<u>\$(210,947)</u>	<u>(472,403)</u>

Proceeds from sales of fixed maturities classified as available for sale were \$36,746,743 and \$26,103,229 in 2006 and 2005, respectively. Gross gains of \$28,968 and \$23,027 and gross losses of \$207,500 and \$365,573 were realized on fixed maturity sales for the years ended December 31, 2006 and 2005, respectively. Proceeds from sales of equity securities were \$2,478,985 and \$5,492,397 in 2006 and 2005, respectively. Gross gains of \$8,000 and \$26,829 were realized on the sale of equity securities for the years ended December 31, 2006 and 2005, respectively, and gross losses of \$40,415 and \$156,686 were realized on equity security sales for the years ended December 31, 2006 and 2005, respectively.

(4) Receivables

A summary of receivables at December 31, 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
Insurance premiums due from agents	\$179,997	200,269
Receivables under construction contracts:		
Amounts billed	483,146	797,215
Recoverable costs in excess of billings on uncompleted contracts	40,000	406,847
Billings in excess of costs on uncompleted contracts	(210,389)	(11,792)
Retainage, due on completion of contracts	<u>453,041</u>	<u>596,104</u>
Total receivables under construction contracts	765,798	1,788,374
Other	<u>47,482</u>	<u>32,345</u>
Total receivables	993,277	2,020,988
Less allowances for doubtful accounts	<u>(101,231)</u>	<u>(302,606)</u>
Total receivables, net	<u>\$892,046</u>	<u>1,718,382</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 2007.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(5) Property and Equipment

A summary of property and equipment at December 31, 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
Building	\$16,246,615	16,021,112
Land	800,000	800,000
Equipment and vehicles	1,488,938	1,475,579
Furniture and fixtures	<u>856,771</u>	<u>856,771</u>
	19,392,324	19,153,462
Less accumulated depreciation	<u>8,719,807</u>	<u>8,279,128</u>
	<u>\$10,672,517</u>	<u>10,874,334</u>

Useful lives for depreciation purposes are five years for equipment and vehicles, fifteen years for furniture and fixtures and forty years for the building. Depreciation expense in 2006 and 2005 was \$440,678 and \$505,202, respectively.

Future minimum rental income to be generated by leasing a portion of the building under non-cancelable operating leases as of December 31, 2006 are estimated to be \$404,304 for 2007, \$316,104 for 2008 and \$36,000 for 2009. Rental income earned in 2006 and 2005 was \$396,526 and \$426,293, 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>2006</u>	<u>2005</u>
Balance at January 1	\$23,102,777	23,169,971
Less reinsurance recoverable	<u>3,896,869</u>	<u>3,870,088</u>
Net balance at January 1	19,205,908	19,299,883
Incurred related to:		
Current year	2,942,000	3,807,000
Prior years	<u>(528,711)</u>	<u>158,966</u>
Total incurred	2,413,289	3,965,966
Payments related to:		
Current year	17,000	610,000
Prior years	<u>2,476,384</u>	<u>3,449,941</u>
Total payments	2,493,384	4,059,941
Net balance at December 31	19,125,813	19,205,908
Plus reinsurance recoverable	<u>2,954,488</u>	<u>3,896,869</u>
Balance at December 31	<u>\$22,080,301</u>	<u>23,102,777</u>

The decrease in reserves for unpaid losses and loss adjustment expenses in 2006 from 2005 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 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.

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(7) Notes Payable to Banks

At December 31, 2006, the Company has a \$10,000,000 bank line of credit with two financial institutions. 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, 2006 and 2005. 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 bankline.

(8) Long-term Debt

A summary of long-term debt at December 31, 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
Term Loan II due 2008	\$ 2,000,000	3,000,000
Term Loan III due 2009	7,277,777	7,944,444
Mortgage Note due 2009	<u>2,028,511</u>	<u>2,939,544</u>
	<u>\$11,306,288</u>	<u>13,883,988</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 \$7,277,777 at December 31, 2006. 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, 2006. The proceeds were used to prepay the balance of the Convertible Notes due 2022.

On December 17, 2001, the Company obtained a \$5,000,000 term loan from a financial institution, which is payable in quarterly installments of \$250,000. The term loan, due 2008 has a balance of \$2,000,000 at December 31, 2006. The interest rate varies based on LIBOR plus 190 basis points in effect during the borrowing period. The interest rate cannot exceed 7.4%. The loan agreement contains certain limitations on borrowings, minimum statutory capital levels and requires maintenance of certain ratios. The Company was in compliance with these covenants at December 31, 2006. The proceeds were used to prepay \$5,005,000 of the Convertible Notes due 2022.

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 \$2,028,511 at December 31, 2006. 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, 2006.

Principal payments on long-term debt are \$2,641,354, \$2,700,103 and \$5,964,831 for the years 2007 through 2009, respectively. Interest expense paid in 2006 and 2005 amounted to \$891,939 and \$919,850, respectively.

The fair value at December 31, 2006 of the mortgage and the term loans approximate carrying value.

(9) Income Taxes

The components of income tax expense for the years ended December 31, 2006 and 2005 were as follows:

	<u>2006</u>	<u>2005</u>
Current Taxes:		
Federal	\$2,122,825	2,603,932
State	<u>85,000</u>	<u>85,000</u>
	<u>2,207,825</u>	<u>2,688,932</u>
Deferred Taxes:		
Federal	366,340	1,709,085
State	--	---
	<u>366,340</u>	<u>1,709,085</u>
Total	<u>\$2,574,165</u>	<u>4,398,017</u>

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The effective income tax rate, as a percentage of earnings before income taxes for the years ended December 31, 2006 and 2005 was as follows:

	<u>2006</u>	<u>2005</u>
Federal statutory tax rate	34.0%	34.0%
State income tax	.7	.4
Other, net	<u>(.7)</u>	<u>(.3)</u>
Effective income tax rate	<u>34.0%</u>	<u>34.1%</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, 2006 and 2005 are presented below:

	<u>2006</u>	<u>2005</u>
Deferred Tax Assets:		
Reserves for losses and loss adjustment expenses	\$ 726,032	805,989
Unearned premiums	271,542	289,652
Allowance for doubtful accounts	34,418	102,886
State effect of temporary differences and net operating loss carryforward	761,284	434,938
Unrealized losses on investments	--	188,738
Stock based compensation	64,221	--
Alternative minimum tax credit carryforward	--	<u>168,879</u>
Total gross deferred tax assets	1,857,497	1,991,082
Less valuation allowance	<u>(761,284)</u>	<u>(623,676)</u>
Net deferred tax assets	\$1,096,213	1,367,406
Deferred Tax Liabilities:		
Plant and equipment	\$ 547,701	518,116
Deferred policy acquisition costs	408,415	414,531
Unrealized gains on investments	29,225	--
Other	<u>135,549</u>	<u>63,872</u>
Total gross deferred tax liabilities	<u>1,120,890</u>	<u>996,519</u>
Net deferred tax assets (liabilities)	\$ <u>(24,677)</u>	<u>370,888</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, 2006 and 2005.

The most significant component of the state gross deferred asset is the net operating loss carryforward for the State of Connecticut which amounted to \$15,225,683 as of December 31, 2006 which expires in 2020 through 2026. In 2006 and 2005, 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. The change in the valuation allowance is due to the expiration of the State of Connecticut net operating loss carryforwards offset in part by the current tax loss generated by the Connecticut domiciled companies.

Taxes paid in 2006 and 2005 were \$2,072,304 and \$2,479,557, respectively.

(10) Pension and Profit Sharing Plans

The Company maintains ACMAT 401(k) plan for the benefit of non-union employees. The Company contributed \$75,000 to the ACMAT 401(k) Plan in 2006 and 2005. Costs associated with operating the Plan are borne by the Company and were insignificant for each of the years ended December 31, 2006 and 2005.

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The Company participated in various multi-employer defined contribution plans for its union employees. Upon withdrawal from these plans, the Company may be liable for its share of the unfunded vested liabilities of the plans. Such obligations, if any, of the Company are not determinable at December 31, 2006.

(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, 2006 and 2005, the amounts included in AOCI for these losses of \$470 in 2006 and losses of \$121,745 in 2005 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, 2007, 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 2006 and 2005, ACMAT repurchased and retired, in the open market and in privately negotiated transactions, 29,000 and 29,744, respectively, shares of its Common Stock at an average price of \$23.69 and \$15.99 per share, respectively. The Company also repurchased and retired during 2006 and 2005, in the open market and in privately negotiated transactions, 308,575 and 46,130, respectively, shares of its Class A Stock at an average price of \$21.02 and \$13.29 per share, respectively.

Under applicable insurance regulations, ACMAT's insurance subsidiary is restricted as to the amount of dividends they may pay, without the prior approval of any insurance department and are limited to approximately \$5,843,000 in 2007.

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 \$31,679,692 and \$30,280,936 at December 31, 2006 and 2005, respectively, and their statutory net income for the years ended December 31, 2006 and 2005 was \$5,842,852 and \$5,186,375, 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.

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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, 2006 and 2005:

	<u>Earnings</u>	<u>Weighted Average Shares Outstanding</u>	<u>Per-Share Amount</u>
<u>2006:</u>			
Basic EPS:			
Earnings available to stockholders	4,999,319	2,056,421	\$2.43
Effect of Dilutive Securities:			
Stock options	---	<u>114,813</u>	
Diluted EPS:			
Earnings available to stockholders	<u>4,999,319</u>	<u>2,171,234</u>	<u>\$2.30</u>
<u>2005:</u>			
Basic EPS:			
Earnings available to stockholders	\$8,483,722	2,249,655	\$3.77
Effect of Dilutive Securities:			
Stock options	---	<u>67,715</u>	
Diluted EPS:			
Earnings available to stockholders	<u>\$8,483,722</u>	<u>2,317,370</u>	<u>\$3.66</u>

(14) Stock – Based Incentive 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.

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 options was \$10.60. Total stock-based compensation expense totaled \$188,886 for the year ended December 31, 2006. The tax benefit recognized on stock-based compensation totaled \$64,221 for the year ended December 31, 2006.

As of December 31, 2006 there were 378,000 stock options outstanding of which 132,135 were not yet vested. The compensation costs related to non-vested share compensation arrangements granted but not yet recognized was approximately \$250,000 as of December 31, 2006. The Company expects to recognize that cost over a weighted average period of 3.4 years.

The pro forma fair value of stock-based compensation in the Company's stock for the years ended December 31, 2006 and 2005 was as follows:

	<u>2006</u>	<u>2005</u>
Net earnings as reported	\$4,999,319	8,483,722
Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects	124,665	---
Deduct: Stock-based compensation expense determined under fair value based method, net of related tax effects	<u>(124,665)</u>	<u>(267,297)</u>
Net earnings, pro forma	<u>\$4,999,319</u>	<u>8,216,425</u>
Earnings per share		
Basic and diluted – as reported	\$2.43/2.30	3.77/3.66
Basic and diluted – pro forma	\$2.43/2.30	3.65/3.55

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The fair value effect of stock options reported in Note 1, Stock-Based Compensation, is derived by application of a variation of the Black-Scholes option pricing model.

Historical information was the primary basis for the selection of the expected volatility, expected dividend yield and expected lives of the options. The risk-free interest rate was selected based upon yields of the U.S. Treasury issues with a term equal to the expected life of the option being valued.

	<u>2005</u>
Expected life of stock options, in years	6
Expected volatility of ACMAT stock	30.0
Risk-free interest rate	4.0
Expected annual dividend yield	---
Expected annual forfeiture rate	---

The following table shows the stock option activity for the Company during 2006 and 2005.

	Option Shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2004	<u>324,500</u>	\$9.58		
2005 activity:				
Granted	92,000	\$13.25		
Exercised	(7,500)	\$ 9.00		
Canceled	--			
Outstanding at December 31, 2005	<u>409,000</u>	\$10.42		
2006 activity:				
Granted	--			
Exercised	(31,000)	\$ 8.22		
Canceled	--			
Outstanding at December 31, 2006	<u>378,000</u>	\$10.60	6.47	\$1,854,846
Exercisable at December 31, 2006	<u>245,865</u>	\$10.49	6.36	\$1,206,460
Expected to Vest	<u>132,135</u>	\$10.79	6.68	\$648,386

Of the 409,000 outstanding options at December 31, 2005, 234,135 were exercisable. Proceeds from stock options exercised in 2006 and 2005 were \$254,750 and \$67,500, respectively. Tax benefits related to stock options exercised in 2006 and 2005 were \$118,354 and \$13,133, respectively. Intrinsic value related to stock options exercised in 2006 and 2005 were \$152,117 and \$36,803, respectively.

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of exercise price	Number Outstanding	Weighted average remaining contractual life	Weighted average exercise price	Grant Year	Number exercisable
\$ 7.25	30,000	3.95	\$ 7.25	2000	30,000
9.00	167,000	5.47	\$9.00	2002	97,000
12.22	74,000	7.20	\$12.22	2004	61,200
11.40	20,000	7.20	\$11.40	2004	12,000
\$13.25	<u>87,000</u>	8.48	\$13.25	2005	<u>45,665</u>
\$7.25-13.25	<u>378,000</u>	6.47	\$10.60		<u>245,865</u>

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(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 has been engaged have 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 has 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.

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 claims relating to materials containing asbestos. No specific claims for monetary damages are asserted in these actions. Although it is early in the litigation process, 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, primarily through ACSTAR, 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. The United Coastal Liability Insurance operating segment offered specific lines of liability insurance as an approved non-admitted excess and surplus lines insurer in forty-seven states, Puerto Rico, the Virgin Islands and the District of Columbia. United Coastal offered claims made and occurrence policies for specific specialty lines of liability insurance through certain excess and surplus lines brokers who are licensed and regulated by the state insurance department(s) in the state(s) in which they operate. United Coastal offered general, asbestos, lead, pollution and professional liability insurance nationwide to specialty trade contractors, environmental contractors, property owner, storage and treatment facilities and professionals. United Coastal also offered products liability insurance to manufacturers and distributors.

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>2006</u>	<u>2005</u>
Revenues:		
ACSTAR Bonding	\$16,204,242	12,280,831
ACMAT Contracting	9,520,262	8,931,291
United Coastal Liability Insurance	--	<u>3,968,019</u>
	<u>\$25,724,504</u>	<u>25,180,141</u>
Operating Earnings (Loss):		
ACSTAR Bonding	\$8,930,386	6,390,789
ACMAT Contracting	(465,334)	(355,271)
United Coastal Liability Insurance	--	<u>429,321</u>
	<u>\$8,465,052</u>	<u>6,464,839</u>
Depreciation and Amortization:		
ACSTAR Bonding	\$(99,988)	104,102
ACMAT Contracting	<u>482,934</u>	<u>439,140</u>
	<u>\$382,946</u>	<u>543,242</u>
Identifiable Assets:		
ACSTAR Bonding	\$100,630,884	101,794,119
ACMAT Contracting	<u>28,362,450</u>	<u>33,884,167</u>
	<u>\$128,993,334</u>	<u>135,678,286</u>
Capital Expenditures:		
ACSTAR Bonding	13,359	\$12,370
ACMAT Contracting	<u>225,503</u>	<u>420,766</u>
	<u>\$238,862</u>	<u>433,136</u>

The components of revenue for each segment are as follows:

	<u>2006</u>	<u>2005</u>
ACSTAR Bonding:		
Premiums	\$12,437,099	9,842,356
Investment income, net	4,047,782	2,626,180
Capital losses	(179,435)	(14,809)
Other income (expense)	<u>(101,204)</u>	<u>(172,896)</u>
	<u>\$16,204,242</u>	<u>12,280,831</u>
ACMAT Contracting:		
Contract revenues	\$6,086,702	5,527,900
Investment income, net	772,068	93,806
Capital losses	(31,512)	--
Inter-segment revenue:		
Rental income	316,598	752,425
Underwriting services and agency commissions	1,980,422	2,130,607
Other income	<u>395,984</u>	<u>426,553</u>
	<u>\$9,520,262</u>	<u>8,931,291</u>
United Coastal Liability Insurance:		
Premiums	\$ --	3,137,666
Investment income, net	--	1,260,364
Capital gains (losses)	--	(457,594)
Other income	<u>--</u>	<u>27,583</u>
	<u>\$ --</u>	<u>3,968,019</u>

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

	<u>2006</u>	<u>2005</u>
Revenue:		
Total revenue for reportable segments	\$25,724,504	25,180,141
Inter-segment eliminations	(1,525,173)	(1,977,109)
Sale of subsidiary	<u>--</u>	<u>7,336,667</u>
	<u>\$24,199,331</u>	<u>30,539,699</u>
Operating Earnings:		
Total operating earnings for reportable segments	\$8,465,052	6,464,839
Interest expense	(891,568)	(919,767)
Sale of subsidiary	<u>--</u>	<u>7,336,667</u>
	<u>\$7,573,484</u>	<u>12,881,739</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.

Our Services

ACMAT provides design and construction services to commercial, industrial, corporate and institutional customers.

The Company focuses on renovating interiors of existing facilities, as well as new building construction.

ACMAT's Insurance Group includes ACSTAR Insurance Company, and AMINS, Inc. ACSTAR, licensed nationwide, provides surety bonds for prime contractors, specialty trade, environmental remediation and asbestos abatement contractors and miscellaneous surety. AMINS is an insurance brokerage firm.

Stock Market Information

As of December 6, 2004 both stocks 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>2006</u>		<u>2005</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
Common Stock				
1st Quarter	25.25	17.00	15.00	9.56
2nd Quarter	22.00	17.20	20.00	15.00
3rd Quarter	22.00	20.00	20.00	20.00
4th Quarter	23.50	22.00	25.25	17.00
Class A Stock				
1st Quarter	17.00	16.15	12.95	12.00
2nd Quarter	19.25	16.55	14.00	12.00
3rd Quarter	22.05	18.80	14.15	13.75
4th Quarter	25.00	21.50	17.00	14.00

Annual Meeting

The annual meeting of stockholders will be held on June 14, 2007 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 16, 2007 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.

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Chairman, President &
Chief Executive Officer

Henry W. Nozko III
Assistant Vice President

Victoria C. Nozko

John C. Creasy
Former Chief Executive Officer
Danbury Hospital

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

Andrew W. Sullivan, Jr.
Retired Partner of KPMG LLP

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

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Senior Vice President,
Chief Financial Officer

Robert H. Frazer, Esq.
Vice President,
General Counsel, Secretary

David A. Price
Vice President

Henry W. Nozko III
Assistant Vice President

Managers

Maurice C. Shea
Controller

Ray A. Suite
Estimating Manager

Project Managers
Lawrence J. Chevian
J. Marshall Reed
J. Parris Reed

Robert Winchell
Building Manager

ACSTAR Insurance Company

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Chairman, President &
Chief Executive Officer

Michael P. Cifone
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