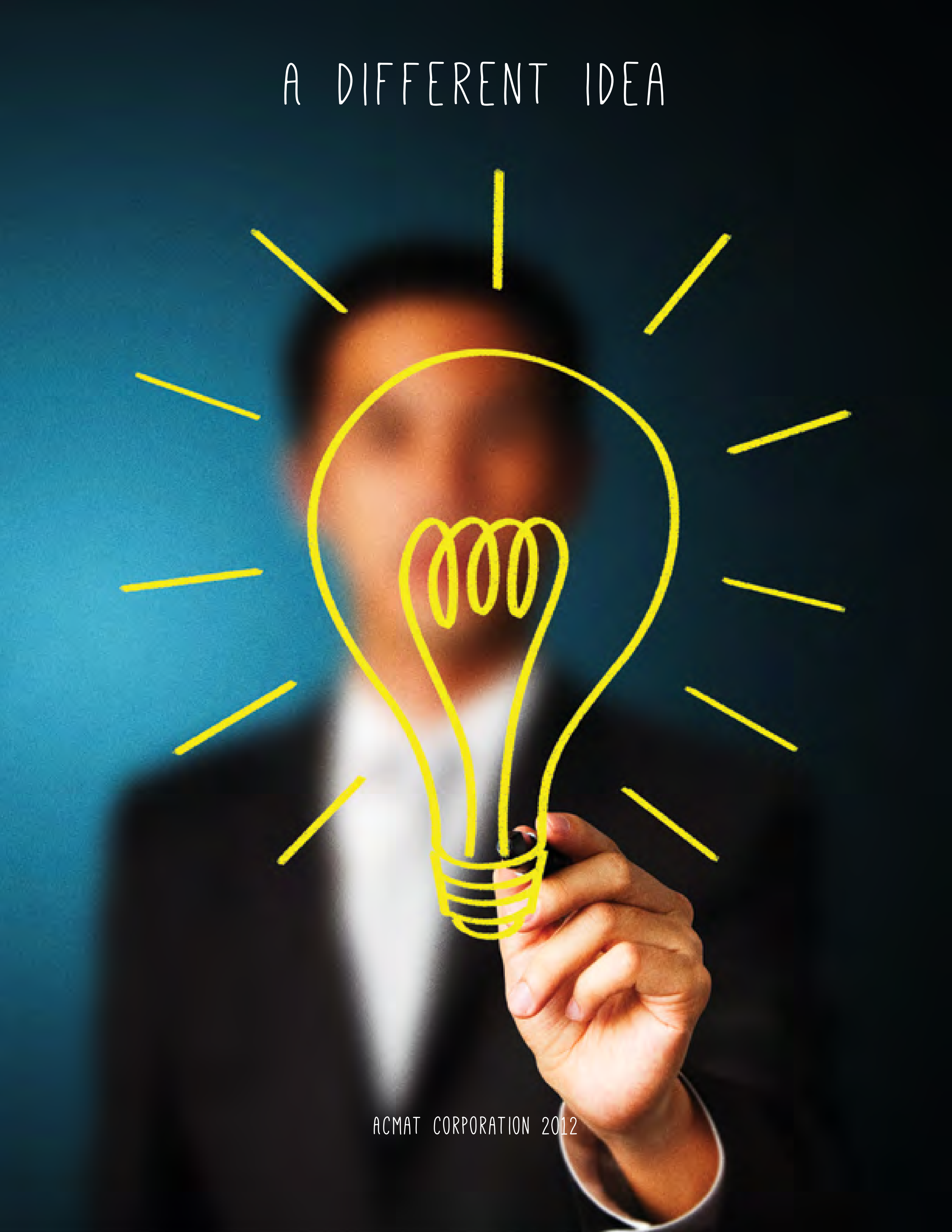
# A DIFFERENT IDEA



ACMAT CORPORATION 2012

# WHAT DEFINES A COMPANY?

## IS IT PRODUCTS…
## SERVICES…
## VALUES…
## TRADITIONS?

*For over six decades one quality has always defined us. We are always open to trying something new.*

*And we have always challenged traditional ways of doing business. Through our subsidiary, ACSTAR Insurance Company, we've departed from the traditional policies and protocol that constrain the giants of the surety industry to better serve our clients. The result has been ACSTAR's continued profitability, even as others have faltered.*

*We see possibilities where others see problems.*

*We embrace the challenges and opportunities to come. We're confident that, by continuing to embrace new ideas, we will continue to prosper. In fact, in both favorable and unfavorable economic climates, we have realized a near perfect record of positive earnings and shareholder value.*

# TO OUR SHAREHOLDERS AND CUSTOMERS:

During 2012 we continued to face the challenges of a very weak construction market. Still we generated solid results. Net income was $1,210,532 for 2012 compared to $1,233,676 for 2011. Basic earnings per share increased to $.92 per share for 2012 from $.90 per share for 2011. These returns were accomplished on less revenue of $6,002,771 for 2012 compared to $6,447,544 for 2011. We generated these results by reducing overhead to $3,538,184 during 2012 from $3,927,820 in 2011 and by maintaining an exceptionally low loss ratio at 10% during 2012 compared to 11% during 2011. Investments performed well. Net investment income was $2,529,535 in 2012 vs. $2,627,007 in 2011. We generated net capital gains of $882,414 in 2012 vs. $995,071 in 2011.

Through our subsidiary, ACSTAR Insurance Company, we write surety bonds mostly for non residential construction contractors nationwide. We are licensed to write surety in all 50 states of the U.S. The bonds we write provide buyers of construction an added level of support for achieving the successful performance of a project and the payment of project obligations. ACSTAR is in an industry dominated by giants like Travelers, Liberty Mutual, Zurich and CNA. The top 10 surety companies write 65% of the business. However, these giants are sometimes handicapped by protocol, policy or guidelines to efficiently service contractors that may not pass established underwriting guidelines. Many contractors often view the underwriting process as prohibitive or even intimidating. ACSTAR has established a long track record and reputation for successfully assisting contractors that cannot gain surety credit from the standard underwriting companies. We believe our ability to circumvent the modalities of the underwriting process encountered by many contractors sets us apart as an alternative resource.

The challenges of the weak market we face are substantial. According to the U.S. Department of Commerce the seasonally adjusted annual rate of non residential construction put in place was $570 billion at December 2012, a mere 1.2% increase over the poor performance of $563 billion at December 2011. These figures compare to $720 billion for 2008 without any adjustment for inflation. A recovery in the non residential construction industry has not materialized. The long enduring weakness of the general economy and the construction industry has caused wear and tear on many contractors and sureties. During this last year two sureties discontinued operations and went into receivership and two others were downgraded by A.M. Best Company.

However, there are some signs of improving conditions. For example, FMI, an industry recognized management consulting and investment banking firm, is forecasting an increase in the non residential construction industry by 5% in 2014 and 7% in 2015. The banking industry has improved and construction loans may become easier to obtain. We are not depending or relying upon any forecast particularly since many forecasters have whiffed in the last few years. We're ready for more of the same. However, should the construction industry improve, we will embrace the change with alacrity.

We look ahead with confidence and believe in our ability to continue to prosper. We have a robust balance sheet and surplus ready to deploy and support a substantial increase in premium if and when a recovery occurs and opportunities arise. Based upon recognized NAIC guidelines, our $28.8 million of statutory surplus could support more than a 20 fold increase in premium. During 2012, our surplus actually increased from $28.5 million at December 31, 2011 to $28.8 million at December 31, 2012. On May 30, 2012 A.M. Best Company reaffirmed our high rating of A VI.

Like most enterprises, we face risks. We often rely on bank letters of credit to partially securitize the high risk associated with writing surety bonds. A financial industry meltdown could lead to possible bank defaults on letters of credit, which could result in greater exposure to contactor defaults in connection with the bonds we write. A rash of contractor failures could cause a substantial increase in paid losses and erode surplus. With the open-ended court system that prevails in the nation, there is possible exposure to inflated and unreasonable plaintiff judgments pertaining to our surety business and to the run-off of our casualty business. Since 1995 we have been named, along with many others, in third party bodily injury claims relating to materials containing asbestos. A large number of the claims have been dismissed or settled for nominal payments by us or our insurers. There may be other risks that are unknown.

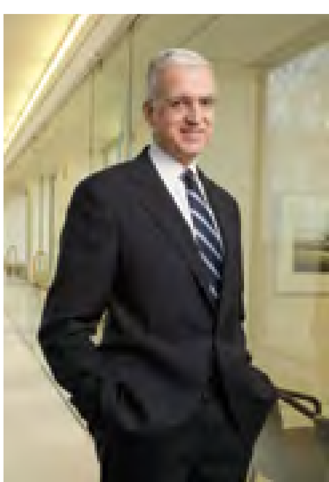
In keeping with and continuing our more than 25 year stock repurchase program, during 2012 the company purchased 120,008 shares of the company's class A stock and 101,240 shares of the company's common stock. The total consideration for all purchases was $5,940,676.00. The shares were canceled and retired and the purchase price has been reflected as an offset to retained earnings. We expect to continue such purchases in the future, but most likely in smaller quantities.

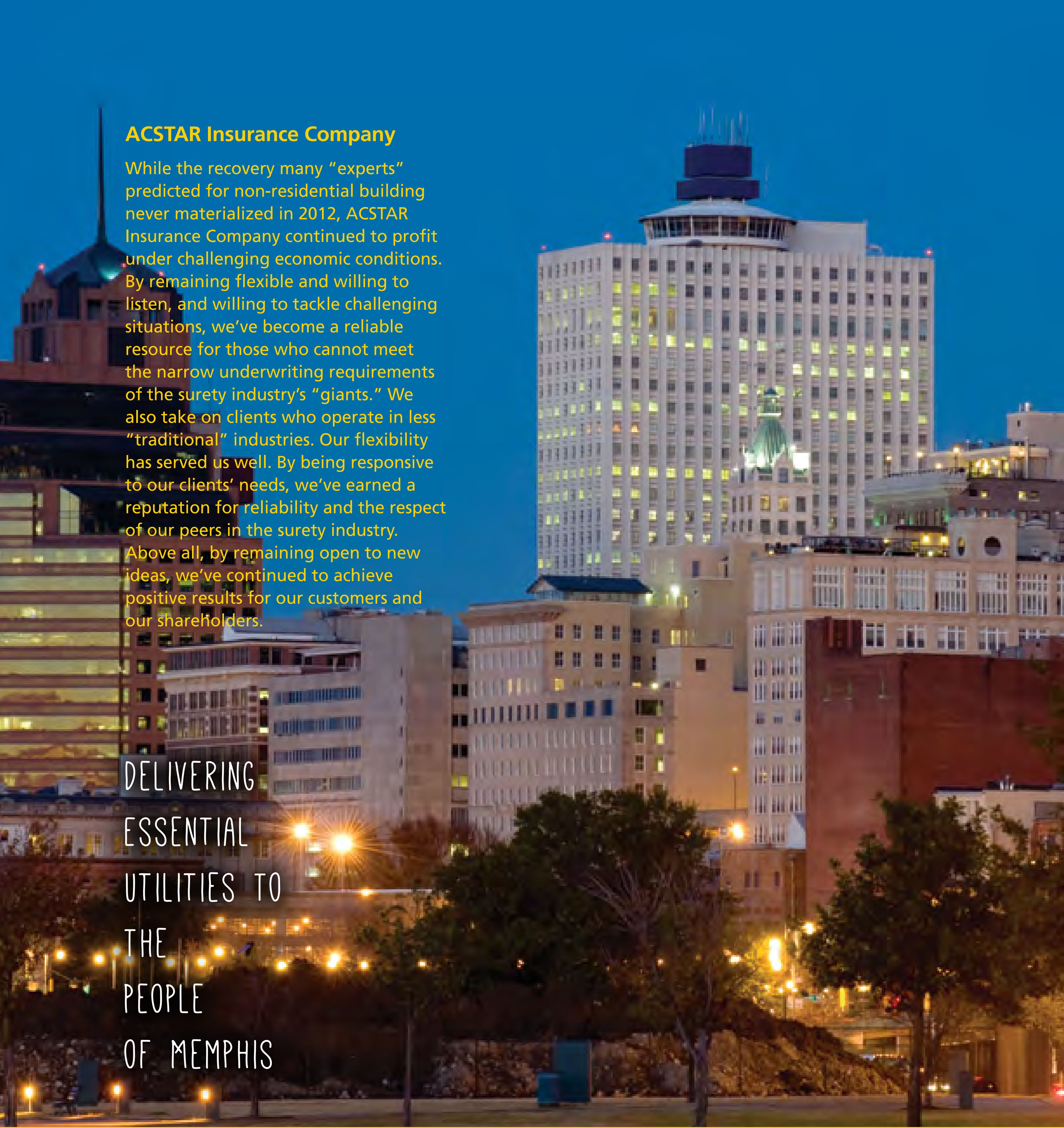
During the last 63 years, whether times have been good or bad, we have achieved a near perfect record of positive earnings and increasing shareholder value. During 2012, we again met our company plan and goal of increasing per share equity, which increased to $30.59 at December 31, 2012 from $29.77 at December 31, 2011.

We thank our employees for their commitment and contributions and we thank our customers for their loyalty and friendship and we thank our shareholders for their confidence and support.

Hank

**Henry W. Nozko, Jr.**
*Chairman, President and*
*Chief Executive Officer*
*April 25, 2013*





## ACSTAR Insurance Company

While the recovery many "experts" predicted for non-residential building never materialized in 2012, ACSTAR Insurance Company continued to profit under challenging economic conditions. By remaining flexible and willing to listen, and willing to tackle challenging situations, we've become a reliable resource for those who cannot meet the narrow underwriting requirements of the surety industry's "giants." We also take on clients who operate in less "traditional" industries. Our flexibility has served us well. By being responsive to our clients' needs, we've earned a reputation for reliability and the respect of our peers in the surety industry. Above all, by remaining open to new ideas, we've continued to achieve positive results for our customers and our shareholders.

# DELIVERING ESSENTIAL UTILITIES TO THE PEOPLE OF MEMPHIS

*Memphis Light, Gas and Water (MLGW) is the nation's largest three-service municipal utility. The company serves nearly 421,000 customers in Memphis, Tennessee and Shelby County. Founded in 1939, the utility provides reliable and affordable electricity, natural gas and water services. In fact, a recent survey found that MLGW's average residential bills are the lowest in the nation. ACSTAR issued surety bonds in excess of $8 million to secure the construction of new electric and natural gas underground distribution systems for subdivisions in Memphis and its surrounding communities.*

# RECLAIMING A CRITICAL RESOURCE IN NORTH CAROLINA

*According to the State Climate Office of North Carolina, "drought is a part of North Carolina's climate." The Triangle Wastewater Treatment Plant (TWWTP) provides a service to residential, commercial, and industrial users in Southeast Durham County and Western Wake County. TWWTP's wastewater collection system includes approximately 105 miles of sewer lines and 1,742 manholes. The treatment plant processes an average of nearly six million gallons of wastewater per day. ACSTAR provided a $1.5 million bond for the operations and maintenance of this critical facility.*

| **Assets** | **2012** | **2011** |
|---|---|---|
| Investments: | | |
| Fixed maturities (Amortized cost of $48,474,904 in 2012 and $57,470,706 in 2011) | $ 49,867,005 | 58,507,044 |
| Equity securities (Historical cost of $14,955,554 in 2012 and $12,439,035 in 2011) | 14,438,827 | 11,255,244 |
| Short-term investments, at cost which approximates fair value | 2,435,084 | 6,654,516 |
| Total investments | 66,740,916 | 76,416,804 |
| Cash and cash equivalents | 6,784,790 | 9,968,438 |
| Accrued interest receivable | 411,947 | 500,296 |
| Premiums receivable, net of allowance for doubtful accounts of $56,520 in 2012 and $48,266 in 2011 | 107,918 | 424,358 |
| Other receivables | 277,952 | 497,427 |
| Reinsurance recoverable | 1,858,971 | 2,775,428 |
| Prepaid expenses | 147,808 | 71,716 |
| Income taxes receivable | - | 1,015,135 |
| Deferred income taxes, net | 526,289 | 1,108,753 |
| Property and equipment, net | 5,330,603 | 1,617,923 |
| Deferred policy acquisition costs | 126,622 | 186,858 |
| Ceded unearned premiums | 130,576 | 141,717 |
| Other assets | 1,404,202 | 801,422 |
| Intangibles | 1,920,360 | 1,920,360 |
| Total assets | $ 85,768,954 | 97,446,635 |

| **Liabilities and Stockholders' Equity** | | |
|---|---|---|
| Reserves for losses and loss adjustment expenses | $ 15,417,199 | 17,506,782 |
| Unearned premiums | 893,373 | 1,241,007 |
| Collateral held | 24,907,307 | 28,500,822 |
| Reinsurance premiums payable | 60,233 | 57,266 |
| Accounts payable and accrued liabilities | 1,606,124 | 2,297,418 |
| Long-term debt | 7,214,286 | 7,142,857 |
| Total liabilities | 50,098,522 | 56,746,152 |
| | | |
| Common Stock (No par value; 3,500,000 shares authorized; 367,306 shares issued and outstanding) | 367,306 | 468,546 |
| Class A Stock (No par value; 10,000,000 shares authorized; 798,647 shares issued and outstanding) | 798,647 | 898,655 |
| Retained earnings | 33,926,733 | 39,430,816 |
| Accumulated other comprehensive income (loss) | 577,746 | (97,534) |
| Total stockholders' equity | 35,670,432 | 40,700,483 |
| Total liabilities and stockholders' equity | $ 85,768,954 | 97,446,635 |

*See Notes to Consolidated Financial Statements*

**ACMAT CORPORATION AND SUBSIDIARIES**

*Consolidated Statements of Earnings — For the Years Ended December 31, 2012 and 2011*

| **Revenues** | | **2012** | **2011** |
|---|---|---|---|
| Premiums | $ | 2,388,379 | 2,626,593 |
| Net investment income | | 2,529,535 | 2,627,007 |
| Net realized capital gains | | 882,141 | 995,071 |
| Fee and other income | | 202,716 | 198,873 |
| Total revenues | | 6,002,771 | 6,447,544 |
| **Expenses** | | | |
| Incurred losses and loss adjustment expenses | | 238,167 | 286,904 |
| Amortization of deferred acquisition costs | | 398,011 | 378,775 |
| General and administrative expenses | | 3,538,184 | 3,927,820 |
| Interest expense | | 260,653 | 263,209 |
| Total expenses | | 4,435,015 | 4,856,708 |
| Earnings before income taxes | | 1,567,756 | 1,590,836 |
| Provision for income taxes | | 357,224 | 357,160 |
| Net earnings | $ | 1,210,532 | 1,233,676 |
| Basic earnings per share | | $ 0.92 | $ 0.90 |
| Diluted earnings per share | | $ 0.88 | $ 0.84 |

*See Notes to Consolidated Financial Statements*

**ACMAT CORPORATION AND SUBSIDIARIES**

*Consolidated Statements of Comprehensive Income — For the Years Ended December 31, 2012 and 2011*

| | | **2012** | **2011** |
|---|---|---|---|
| Net earnings | $ | 1,210,532 | 1,233,676 |
| Change in net unrealized gains and losses on investment securities | | 1,023,152 | (1,156,465) |
| Income tax expense (benefit) | | 347,872 | (393,198) |
| Other comprehensive income (loss), net of taxes | | 675,280 | (763,267) |
| Comprehensive income | $ | 1,885,812 | 470,409 |

*See Notes to Consolidated Financial Statements*

| | Common Stock Par value | Class A Stock Par value | Retained Earnings | Accumulated Other Comprehensive Income (loss) | Total Stockholders' Equity |
|---|---|---|---|---|---|
| Balance as of December 31, 2010 | $ 468,546 | 898,655 | 38,193,324 | 665,733 | 40,226,258 |
| Comprehensive income (loss) | | | | | |
| Net unrealized losses on investment securities, net of reclassification | - | - | - | (763,267) | (763,267) |
| Net earnings | - | - | 1,233,676 | - | 1,233,676 |
| Total comprehensive income (loss) | - | - | 1,233,676 | (763,267) | 470,409 |
| Share-based compensation | - | - | 3,816 | - | 3,816 |
| Balance as of December 31, 2011 | $ 468,546 | 898,655 | 39,430,816 | (97,534) | 40,700,483 |
| | | | | | |
| Balance as of December 31, 2011 | $ 468,546 | 898,655 | 39,430,816 | (97,534) | 40,700,483 |
| Comprehensive income | | | | | |
| Net unrealized gains on investment securities, net of reclassification | - | - | - | 675,280 | 675,280 |
| Net earnings | - | - | 1,210,532 | - | 1,210,532 |
| Total comprehensive income | - | - | 1,210,532 | 675,280 | 1,885,812 |
| Acquisition and retirement of 208,508 shares of Class A Stock | - | (208,508) | (4,961,585) | - | (5,170,093) |
| Issuance of 108,500 shares of Class A Stock pursuant to stock options | - | 108,500 | 980,050 | - | 1,088,550 |
| Acquisition and retirement of 101,240 shares of common Stock | (101,240) | - | (2,733,080) | - | (2,834,320) |
| Balance as of December 31, 2012 | $ 367,306 | 798,647 | 33,926,733 | 577,746 | 35,670,432 |

*See Notes to Consolidated Financial Statements*

| | 2012 | 2011 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net earnings | $ 1,210,532 | 1,233,676 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 476,170 | 595,218 |
| Share-based compensation | - | 3,816 |
| Net realized capital gains | (882,141) | (995,071) |
| Deferred income tax expense | 244,268 | 1,214,567 |
| Changes in: | | |
| Accrued interest receivable | 88,349 | 162,149 |
| Receivables | 535,915 | (135,703) |
| Reinsurance recoverable | 916,457 | 979,246 |
| Income taxes receivable | 1,015,135 | (835,838) |
| Deferred policy acquisition costs | 60,236 | (81,759) |
| Prepaid expenses and other assets | (678,872) | (41,830) |
| Reserves for losses and loss adjustment expenses | (2,089,583) | (2,651,019) |
| Unearned premiums, net | (336,493) | (29,742) |
| Collateral held | (3,593,515) | (702,552) |
| Reinsurance premiums payable | 2,967 | 4,145 |
| Accounts payable and accrued liabilities | (709,489) | 183,129 |
| Net cash used for operating activities | (3,740,064) | (1,097,568) |
| **Cash flows from investing activities** | | |
| Proceeds from investments sold, matured or redeemed: | | |
| Fixed maturities sold | 3,966,563 | 3,374,646 |
| Maturities and redemptions | 21,275,816 | 19,530,335 |
| Equity securities | 32,853,419 | 29,634,291 |
| Purchases of: | | |
| Fixed maturities | (16,065,125) | (12,416,731) |
| Equity securities | (35,049,833) | (35,608,583) |
| Short-term investments, net | 4,219,432 | (1,029,065) |
| Sale of building, net of commission | - | 2,716,000 |
| Capital expenditures | (3,799,422) | (764,947) |
| Net cash provided by investing activities | 7,400,850 | 5,435,946 |
| **Cash flows from financing activities** | | |
| Additional borrowing under term loan facility | 1,500,000 | - |
| Repayments of long-term debt | (1,428,571) | (1,428,571) |
| Acquisition and retirement of common shares | (2,834,320) | - |
| Issuance of Class A shares pursuant to stock options | 1,088,550 | - |
| Acquisition and retirement of Class A shares | (5,170,093) | - |
| Net cash used for financing activities | (6,844,434) | (1,428,571) |
| Net change in cash and cash equivalents | (3,183,648) | 2,909,807 |
| Cash and cash equivalents, beginning of period | 9,968,438 | 7,058,631 |
| Cash and cash equivalents, end of period | $ 6,784,790 | 9,968,438 |
| Supplemental disclosure of cash flows information: | | |
| Cash (received from) paid for income taxes | (912,060) | 170,000 |
| Cash paid for interest | 245,843 | 263,209 |

*See Notes to Consolidated Financial Statements*

## (1) Summary of Significant Accounting Policies

### (a) *Basis of Presentation*

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

These consolidated financial statements are prepared under U.S. generally accepted accounting principles (GAAP). 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, claims, and expenses during the reporting period. Actual results could differ from those estimates. All material intercompany transactions and balances have been eliminated. Certain prior period balances have been reclassified to conform to the current period's presentation.

### (b) *Business*

ACMAT, through ACSTAR, offers surety bonds for prime, sub-prime, specialty trade, environmental, asbestos and lead abatement contractors and miscellaneous obligations. ACSTAR also provides other miscellaneous surety such as workers' compensation bonds, supply bonds, subdivision bonds, and license and permit bonds. Prior to 2010, ACMAT provided construction contracting services to commercial and governmental customers.

### (c) *Investments*

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements or other similar factors. As a result, the Company considers all of its fixed income and equity securities as available-for-sale, and as such, they are carried at fair value, with unrealized gains or losses, net of tax, charged or credited directly to stockholders' equity. Fixed maturities include bonds, notes and redeemable preferred stocks. Equity securities reflect investment in common stock, non-redeemable preferred stock and money market funds.

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 effective 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 recognize an impairment loss on securities that were not written-down in prior reporting periods.

Short-term investments, consisting of U.S. Government money market funds, 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 cost basis is in excess of fair 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 the security's cost basis has been in excess of fair value, the financial condition and the near-term prospects of the issuer, and the Company's intent to sell the investment before its anticipated recovery in value.

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, 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 issuer. 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 trailing 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 impairment 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 premium taxes, 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 based upon the respective estimated useful lives of the assets. Certain costs related to construction-in-progress are capitalized in property and equipment and commence depreciation upon being placed in-service. 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 suggest that the asset might be impaired. The Company has not impaired any intangible assets.

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

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 underlying 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 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 composition of the assets pledged.

(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 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. Included in the reinsurance recoverables balance as of December 31, 2012 and 2011 are recoverables on paid losses and loss adjustment expenses of $753 and $32,347, respectively. All reinsurance contracts maintained by the Company qualify as short-duration prospective contracts. A summary of reinsurance premiums written and earned is provided below:

| | Premiums Written | | Premiums Earned | |
|---|---|---|---|---|
| | **2012** | **2011** | **2012** | **2011** |
| Direct | $2,398,041 | 3,053,108 | 2,745,675 | 3,082,850 |
| Assumed | - | - | - | - |
| Ceded | 346,155 | 447,166 | 357,296 | 456,257 |
| Net | $ 2,051,886 | 2,605,942 | 2,388,379 | 2,626,593 |

Ceded incurred losses and loss adjustment expenses totaled $36,400 and $57,248 for the years ended December 31, 2012 and 2011, respectively.

(j) ***Statutory Accounting Practices***

The Company's insurance subsidiary, domiciled in the state of Illinois, prepares statutory financial statements in accordance with the accounting practices prescribed or permitted by the insurance department of the state of Illinois. Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. The Company does not have any permitted statutory accounting practices.

(k) ***Revenue Recognition***

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.

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) ***Comprehensive Income***

The following table summarizes reclassification adjustments for other comprehensive income (loss) and the related tax effects for the years ended December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| Unrealized holding gain (loss) arising during period, net of income tax | $ 1,202,298 | (106,520) |
| Less reclassification adjustment for gains included in net earnings, net of income tax expense of $271,494 in 2012 and $338,324 in 2011 | 527,018 | 656,747 |
| Other comprehensive income | $ 675,280 | (763,267) |

(n) ***Share 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, utilizing the assumptions discussed in Note 11. 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).

(o) ***Accounting Standards Updates***

*Testing Indefinite-Lived Intangible Assets for Impairment*

In July 2012, the Financial Accounting Standards Board (FASB) issued updated guidance regarding the impairment test applicable to indefinite-lived intangible assets that is similar to the impairment guidance applicable to goodwill. Under the updated guidance, an entity may assess qualitative factors (such as changes in management, key personnel, strategy, key technology or customers) that may impact the fair value of the indefinite-lived intangible asset and lead to the determination that it is more likely than not that the fair value of the asset is less than its carrying value. If an entity determines that it is more likely than not that the fair value of the intangible asset is less than its carrying value, an impairment test must be performed. The impairment test requires an entity to calculate the estimated fair value of the indefinite-lived intangible asset. If the carrying value of the indefinite-lived intangible asset exceeds its estimated fair value, an impairment loss is recognized in an amount equal to the excess. The updated guidance is effective for the quarter ending March 31, 2013, but early adoption was permitted. The Company adopted the updated guidance effective December 31, 2012, and such adoption did not have any effect on the Company's results of operations, financial position or liquidity.

*Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting for costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost must be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. If application of this guidance would result in the capitalization of acquisition costs that had not previously been capitalized by a reporting entity, the entity may elect not to capitalize those costs. The updated guidance was effective for the quarter ended March 31, 2012 and resulted in a prior period reduction to retained earnings of $234,612 and prior period increase to net earnings of $31,865. The application of the standard increased basic earnings per share $0.02 from $0.88 per share to $0.90 per share and increased diluted earnings per share $0.03 from $0.81 per share to $0.84 per share.

*Presentation of Comprehensive Income*

In June 2011, the FASB issued updated guidance to increase the prominence of items reported in other comprehensive income by eliminating the option of presenting components of comprehensive income as part of the statement of changes in shareholders' equity. The updated guidance requires that all non-owner changes in shareholders' equity be presented either as a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance is to be applied retrospectively and is effective for the quarter ended March 31, 2012 and was applied retrospectively. The updated guidance resulted in a change in the presentation of the Company's consolidated financial statements but did not have any impact on the Company's results of operations, financial position or liquidity.

*Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*

In February 2013, the FASB issued updated guidance to improve the reporting of reclassifications out of accumulated other comprehensive income. The guidance requires an entity to present, either on the face of the statement of income or in the notes, separately for each component of comprehensive income, the current period reclassifications out of accumulated other comprehensive income by the respective line items of net income affected by the reclassification. The updated guidance is effective prospectively for reporting periods beginning after December 15, 2012. The updated guidance will not have any effect on the Company's results of operations, financial position or liquidity.

### (2) Investments

Fixed maturities at December 31, 2012 and 2011 are as follows:

| 2012 | | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| United States government and government obligations | $ | 4,015,893 | 1,718 | 118 | 4,017,493 |
| States and municipalities | | 21,079,689 | 974,260 | 78,457 | 21,975,492 |
| Industrial and miscellaneous | | 8,596,722 | 330,213 | 44,324 | 8,882,611 |
| Mortgage-backed securities | | 12,091,200 | 474,202 | 337,418 | 12,227,984 |
| Redeemable preferred stock | | 2,691,400 | 82,855 | 10,830 | 2,763,425 |
| Total fixed maturities | $ | 48,474,904 | 1,863,248 | 471,147 | 49,867,005 |

| 2011 | | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| United States government and government obligations | $ | 4,022,322 | 8,201 | - | 4,030,523 |
| States and municipalities | | 22,171,109 | 920,746 | 34,789 | 23,057,066 |
| Industrial and miscellaneous | | 8,995,435 | 147,027 | 132,791 | 9,009,671 |
| Mortgage-backed securities | | 20,634,640 | 535,473 | 339,240 | 20,830,873 |
| Redeemable preferred stock | | 1,647,200 | 28,436 | 96,725 | 1,578,911 |
| Total fixed maturities | $ | 57,470,706 | 1,639,883 | 603,545 | 58,507,044 |

The amortized cost and fair value of fixed maturities by contractual maturity follow. 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.

| 2012 | | Amortized Cost | Fair Value |
|---|---|---|---|
| Due in one year or less | $ | 6,503,423 | 6,527,279 |
| Due after one year through five years | | 12,462,608 | 12,956,050 |
| Due after five years through ten years | | 7,686,880 | 8,021,014 |
| Due after ten years | | 9,730,793 | 10,134,678 |
| Mortgage-backed securities | | 12,091,200 | 12,227,984 |
| | $ | 48,474,904 | 49,867,005 |

At December 31, 2012 and 2011, the Company held mortgage-backed securities with a fair value of $12,227,984 and $20,830,873, respectively. Approximately 67% and 79% of the Company's investments in mortgage-backed securities are backed by Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Small Business Administration (SBA) or Federal Home Loan Mortgage Corporation (FHLMC) securities at December 31, 2012 and 2011, respectively.

Included in the Company's investments in mortgage-backed securities are residential collateralized mortgage obligations (CMOs) classified as available for sale with a fair value of $9,241,443 and $13,976,802, respectively. The Company makes investments in 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 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. Approximately 64% and 70% of the Company's CMO holdings are fully collateralized by GNMA, FNMA, SBA, or FHLMC securities at December 31, 2012 and 2011, respectively.

Proceeds from sales of fixed maturities classified as available for sale were $3,966,563 and $3,374,646 in 2012 and 2011, respectively. Gross gains of $320,047 and $80,785 and gross losses of $107,497 and $230,089 were realized on fixed maturity sales for the years ended December 31, 2012 and 2011, respectively.

At December 31, 2012 and 2011, the Company's insurance subsidiary had securities with an aggregate fair value of $4,017,493 and $4,030,523, respectively, on deposit with various state regulatory authorities.

Equity securities at December 31, 2012 and 2011 are as follows:

| **2012** | | Historical Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| Perpetual preferred stocks | $ | 1,692,877 | 116,689 | - | 1,809,566 |
| Common stocks | | 13,262,677 | 485,173 | 1,118,589 | 12,629,261 |
| Total equity securities | $ | 14,955,554 | 601,862 | 1,118,589 | 14,438,827 |

| **2011** | | Historical Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| Perpetual preferred stocks | $ | 2,227,877 | 77,423 | 281,140 | 2,024,160 |
| Common stocks | | 10,211,158 | 551,843 | 1,531,917 | 9,231,084 |
| Total equity securities | $ | 12,439,035 | 629,266 | 1,813,057 | 11,255,244 |

Proceeds from sales of equity securities were $32,853,419 and $29,634,291 in 2012 and 2011, respectively. Gross gains of $1,106,695 and $1,414,407 were realized on the sale of equity securities for the years ended December 31, 2012 and 2011, respectively, and gross losses of $437,104 and $270,032 were realized on the sale of equity securities for the years ended December 31, 2012 and 2011, respectively.

The following tables summarize, for all investments in an unrealized loss position at December 31, 2012 and 2011, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position:

| | | Less than 12 Months | | | |
|---|---|---|---|---|---|
| | | **2012** | | **2011** | |
| | | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Fixed maturities: | | | | | |
| United States government and government obligations | $ | 800,900 | 118 | - | - |
| States and municipalities | | 2,197,876 | 38,475 | 60,431 | 605 |
| Industrial and miscellaneous | | 1,296,823 | 44,324 | 2,968,268 | 132,791 |
| Mortgage-backed securities | | 1,185,911 | 332,470 | 6,059,765 | 234,085 |
| Redeemable preferred stock | | 551,670 | 10,830 | - | - |
| Total fixed maturities | | 6,033,180 | 426,217 | 9,088,464 | 367,481 |
| Equity securities: | | | | | |
| Perpetual preferred stock | | - | - | 137,000 | 63,000 |
| Common stock | | 8,244,905 | 696,289 | 4,877,388 | 1,359,792 |
| Total equity securities | | 8,244,905 | 696,289 | 5,014,388 | 1,422,792 |
| Total | $ | 14,278,085 | 1,122,506 | 14,102,852 | 1,790,273 |

| | | Greater than 12 Months | | | |
|---|---|---|---|---|---|
| | | **2012** | | **2011** | |
| | | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Fixed maturities: | | | | | |
| States and municipalities | $ | 873,800 | 39,982 | 1,807,325 | 34,184 |
| Mortgage-backed securities | | 167,796 | 4,948 | 498,060 | 105,155 |
| Redeemable preferred stock | | - | - | 390,775 | 96,725 |
| Total fixed maturities | | 1,041,596 | 44,930 | 2,696,160 | 236,064 |
| Equity securities: | | | | | |
| Perpetual preferred stock | | - | - | 523,260 | 218,140 |
| Common stock | | 2,372,400 | 422,300 | 688,400 | 172,125 |
| Total equity securities | | 2,372,400 | 422,300 | 1,211,660 | 390,265 |
| Total | $ | 3,413,996 | 467,230 | 3,907,820 | 626,329 |

| | Total | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Fixed maturities: | | | | |
| United States government | | | | |
| and government obligations | $ 800,900 | 118 | - | - |
| States and municipalities | 3,071,676 | 78,457 | 1,867,756 | 34,789 |
| Industrial and miscellaneous | 1,296,823 | 44,324 | 2,968,268 | 132,791 |
| Mortgage-backed securities | 1,353,707 | 337,418 | 6,557,825 | 339,240 |
| Redeemable preferred stock | 551,670 | 10,830 | 390,775 | 96,725 |
| Total fixed maturities | 7,074,776 | 471,147 | 11,784,624 | 603,545 |
| Equity securities: | | | | |
| Perpetual preferred stock | - | - | 660,260 | 281,140 |
| Common stock | 10,617,305 | 1,118,589 | 5,565,788 | 1,531,917 |
| Total equity securities | 10,617,305 | 1,118,589 | 6,226,048 | 1,813,057 |
| Total | $ 17,692,081 | 1,589,736 | 18,010,672 | 2,416,602 |

The following table summarizes for all fixed maturity and equity securities available for sale for which fair value is less than 80% of amortized cost at December 31, 2012, the gross unrealized investment loss by length of time those securities have continuously been in an unrealized loss position of greater than 20% of amortized cost:

| | Period for Which Fair Value is Less than 80% of Amortized Cost | | | | |
|---|---|---|---|---|---|
| | Less Than 3 Months | Greater Than 3 Months, Less Than 6 Months | Greater Than 6 Months, Less Than 12 Months | Greater Than 12 Months | Total |
| Industrial and miscellaneous | $ 26,055 | - | - | - | 26,055 |
| Mortgage backed securities | 162,608 | 70,381 | - | 58,462 | 291,451 |
| Total fixed maturities | 188,663 | 70,381 | - | 58,462 | 317,506 |
| Equity securities | 193,734 | 92,796 | 103,972 | - | 390,502 |
| Total | $ 382,397 | 163,177 | 103,972 | 58,462 | 708,008 |

Approximately 55% of the unrealized losses reported above relate to common stocks of domestic banks and energy producers, which were subject to disruption in the capital markets throughout December 2012 in response to uncertainty in the Federal government. Market prices have rebounded in early 2013 following a general stabilization of the markets. Excluding the impact of these temporary declines in the fair value of the common stocks of banks and energy producers, the unrealized losses at December 31, 2011 represent less than 1% of the combined fixed maturity and equity securities portfolios on a pretax basis and approximately 1% of shareholders' equity on an after-tax basis.

A summary of net investment income for the years ended December 31, 2012 and 2011 follows:

| | 2012 | 2011 |
|---|---|---|
| Taxable interest | $ 1,396,810 | 1,813,129 |
| Tax-exempt interest | 613,966 | 627,615 |
| Dividend income | 602,388 | 357,399 |
| Investment expenses | (83,629) | (171,136) |
| Net investment income | $ 2,529,535 | 2,627,007 |

### (3) Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on a fair value hierarchy. The hierarchy is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets, requiring that observable inputs be used in the valuations when available. The fair value 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.

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, i.e., 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 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 of U.S. Treasury securities are included in the amount disclosed in Level 1 as the estimates are based on unadjusted market prices.

***Equity Securities***

For publicly-traded common 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. Under certain circumstances, 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 fixed maturities. The Company includes the estimate in the amount disclosed in Level 2.

The following tables present the level within the fair value hierarchy at which the Company's financial assets are measured on a recurring basis at December 31, 2012 and 2011.

| **2012** | | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|
| Fixed maturities: | | | | | |
| United States government | | | | | |
| and government obligations | $ | 4,017,493 | - | - | 4,017,493 |
| States and municipalities | | - | 21,975,492 | - | 21,975,492 |
| Industrial and miscellaneous | | - | 8,882,611 | - | 8,882,611 |
| Mortgage-backed securities | | - | 12,227,984 | - | 12,227,984 |
| Redeemable preferred stock | | - | 2,763,425 | - | 2,763,425 |
| Total fixed maturities | | 4,017,493 | 45,849,512 | - | 49,867,005 |
| Equity securities: | | | | | |
| Perpetual preferred stock | | - | 1,809,566 | - | 1,809,566 |
| Common stock | | 12,629,261 | - | - | 12,629,261 |
| Total equity securities | | 12,629,261 | 1,809,566 | - | 14,438,827 |
| Short-term investments | | - | 2,435,084 | - | 2,435,084 |
| Total | $ | 16,646,754 | 50,094,162 | - | 66,740,916 |

| **2011** | | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|
| Fixed maturities: | | | | | |
| United States government | | | | | |
| and government obligations | $ | 4,030,523 | - | - | 4,030,523 |
| States and municipalities | | - | 23,057,066 | - | 23,057,066 |
| Industrial and miscellaneous | | - | 9,009,671 | - | 9,009,671 |
| Mortgage-backed securities | | - | 20,830,873 | - | 20,830,873 |
| Redeemable preferred stock | | - | 1,578,911 | - | 1,578,911 |
| Total fixed maturities | | 4,030,523 | 54,476,521 | - | 58,507,044 |
| Equity securities: | | | | | |
| Perpetual preferred stock | | - | 2,024,160 | - | 2,024,160 |
| Common stock | | 9,231,084 | - | - | 9,231,084 |
| Total equity securities | | 9,231,084 | 2,024,160 | - | 11,255,244 |
| Short-term investments | | - | 6,654,516 | - | 6,654,516 |
| Total | $ | 13,261,607 | 63,155,197 | - | 76,416,804 |

There were no significant transfers between Level 1 and 2 or from level 3 in 2012 or 2011. The Company had no material assets or liabilities that were measured at fair value on a non-recurring basis during the years ended December 31, 2012 and 2011.

### (4) Property and Equipment

A summary of property and equipment at December 31, 2012 and 2011 is as follows:

| | | **2012** | **2011** |
|---|---|---|---|
| Building | $ | 4,275,535 | - |
| Land | | 562,397 | 558,178 |
| Equipment and automobiles | | 1,013,578 | 947,678 |
| Furniture and office fixtures | | 1,069,576 | 878,934 |
| Construction work-in-progress | | - | 736,874 |
| | | 6,921,086 | 3,121,664 |
| Accumulated depreciation | | 1,590,483 | 1,503,741 |
| Property and equipment, net | $ | 5,330,603 | 1,617,923 |

In November 2012 the Company completed construction of its new headquarters in Farmington, CT. Total cost associated with the building, excluding expenditures for land and land improvements, was $4,275,535. The Company sold its predecessor office building in February 2011 to an unrelated party for net proceeds of $2,716,000. The transaction did not result in a realized gain or loss for book reporting purposes.

Useful lives are three to five years for equipment and vehicles, seven years for furniture and fixtures and forty years for the occupied office building. Depreciation expense in 2012 and 2011 was $86,742 and $66,491, respectively.

### (5) 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.

| | | 2012 | 2011 |
|---|---|---|---|
| Balance, January 1 | $ | 17,506,782 | 20,157,801 |
| Less: Reinsurance recoverable | | 2,743,081 | 3,718,182 |
| Net balance, January 1 | | 14,763,701 | 16,439,619 |
| | | | |
| Incurred related to: | | | |
| Current year | | 942,000 | 1,436,000 |
| Prior years | | (703,833) | (1,149,096) |
| Total incurred | | 238,167 | 286,904 |
| | | | |
| Payments related to: | | | |
| Current year | | 4,992 | 22,000 |
| Prior years | | 1,437,895 | 1,940,822 |
| Total payments | | 1,442,887 | 1,962,822 |
| | | | |
| Net balance, December 31 | | 13,558,981 | 14,763,701 |
| Plus: Reinsurance recoverable | | 1,858,218 | 2,743,081 |
| Balance, December 31 | $ | 15,417,199 | 17,506,782 |

The decrease in reserves for losses and loss adjustment expenses from December 31, 2011 to December 31, 2012 represents the payment and settlement of claims and expenses in the normal course of the Company's operations. Incurred losses and loss adjustment expenses declined from 2011 to 2012 following favorable loss development, claim emergence and frequency patterns. Incurred losses and loss adjustment expenses remained consistent with respect to earned premium volume. 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.

Among other lines of insurance, ACMAT provided asbestos and environmental liability insurance primarily to contractors and consultants involved in remediation, removal or treatment of environmental and asbestos conditions. The Company has no exposure to any asbestos or environmental claims associated with general liability policies written with the pre-1986 pollution exclusion which are typically associated with the mass tort environmental and asbestos claims. ACMAT specifically insured asbestos and environmental exposures, which related to third party losses arising out of a contractor's or consultant's operations. Employees of the contractor, consultant, subcontractor, and premises owner are generally excluded from coverage. Most environmental policies were written on a claims-made basis while asbestos liability was written on both claims-made and occurrence basis.

### (6) Long-Term Debt

A summary of debt at December 31, 2012 and 2011 is as follows:

| | | 2012 | 2011 |
|---|---|---|---|
| Term loan due December 2017 | $ | 7,214,286 | 7,142,857 |

In December 2009, the Company obtained a $10,000,000 term loan facility from a financial institution; the Company borrowed an additional $1,500,000 under this facility in April 2012. The term loan, due 2017, is payable in monthly installments of $119,048 and has an unpaid principal balance of $7,214,286 at December 31, 2012. The interest rate varies based on the London Inter-Bank Offering Rate (LIBOR) plus 225 basis points in effect during the borrowing period. In connection with this term loan, the Company entered into an interest rate cap that establishes an interest rate ceiling at 6% on the entire loan balance. 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, 2012.

Principal payments on long-term debt are $1,428,571 for each of the years 2012 through 2017. Interest expense in 2012 and 2011 amounted to $260,653 and $263,209, respectively. The carrying value of long-term debt at December 31, 2012 and 2011 approximates fair value.

At December 31, 2012, the Company has a $4,500,000 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, 2012 and 2011. Under the terms of the line of credit, interest on the outstanding balance is calculated based upon LIBOR plus 225 basis points in effect during the borrowing period. The Company pays an annual commitment fee of 0.375% of the unused portion of the bank line.

**(7) Income Taxes**

The components of income tax expense for the years ended December 31, 2012 and 2011 were as follows:

| | | 2012 | 2011 |
|---|---|---|---|
| Current income tax expense (benefit): | | | |
| Federal | $ | 57,955 | (903,443) |
| State | | 55,001 | 46,036 |
| | | 112,956 | (857,407) |
| Deferred income tax expense: | | | |
| Federal | | 244,268 | 1,214,567 |
| State | | - | - |
| | | 244,268 | 1,214,567 |
| Income tax expense | $ | 357,224 | 357,160 |

The effective income tax rate, as a percentage of earnings before income taxes for the years ended December 31, 2012 and 2011 are as follows:

| | 2012 | 2011 |
|---|---|---|
| Federal statutory tax rate | 34.0% | 34.0% |
| Effect of state income taxes | 2.3% | 2.0% |
| Tax-exempt interest income | (16.0%) | (13.7%) |
| Officers' life insurance | 2.3% | (0.2%) |
| Other | 0.2% | 0.3% |
| Effective income tax rate | 22.8% | 22.4% |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2012 and 2011 are as follows:

| | | 2012 | 2011 |
|---|---|---|---|
| Deferred tax assets: | | | |
| Reserves for losses and loss adjustment expenses | $ | 300,083 | 360,619 |
| Unearned premiums | | 51,870 | 74,752 |
| Allowance for doubtful accounts | | 19,217 | 16,410 |
| Lease loss accrual | | 22,950 | 99,409 |
| Unrealized investment losses | | - | 50,066 |
| Federal net operating loss carryforward | | 463,004 | 481,689 |
| State net operating loss carryforward | | 1,579,820 | 1,411,685 |
| Share based compensation | | 66,157 | 147,821 |
| Other | | 1,736 | - |
| Total gross deferred tax assets | | 2,504,837 | 2,642,451 |
| Valuation allowance | | 1,579,820 | 1,411,685 |
| Adjusted deferred tax assets | | 925,017 | 1,230,766 |
| Deferred tax liabilities: | | | |
| Accumulated depreciation | | 15,699 | 13,339 |
| Deferred policy acquisition costs | | 43,052 | 63,532 |
| Discount on investments | | 42,350 | 45,142 |
| Unrealized investment gains | | 297,627 | - |
| Total gross deferred tax liabilities | | 398,728 | 122,013 |
| Net deferred tax assets | $ | 526,289 | 1,108,753 |

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, 2012 and 2011.

The most significant component of the gross deferred asset is the net operating loss carryforward for the State of Connecticut which amounted to $31,596,403 as of December 31, 2012 and expires between 2020 through 2031. In 2012 and 2011, a valuation allowance is provided to offset the deferred tax asset as management believes that these deferred tax assets are unrealizable. The change of $168,135 in the valuation allowance is due to the current tax operating loss generated by ACMAT and its Connecticut domiciled subsidiaries.

The IRS has conducted an examination of the Company's U.S. income tax returns for the 2006, 2007 and 2008 tax years and no adjustments were required. The Company does not have any tax positions for which the ultimate deductibility is certain, but for which there is uncertainty about the timing of deductibility.

### (8) Employee Benefit Plan

The Company maintains the ACMAT 401(k) plan for the benefit of its employees. The Company contributed $75,000 and $80,000 to the ACMAT 401(k) Plan in 2012 and 2011, respectively. Costs associated with operating the Plan are borne by the Company and were insignificant for each of the years ended December 31, 2012 and 2011.

### (9) Stockholders' Equity

The Company has two classes of common stock; Common Stock and 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.

Under applicable insurance regulations, ACMAT's insurance subsidiary is restricted as to the amount of dividends it may pay to its shareholder, without the prior approval of any insurance department and is limited to $2,877,347 in 2013.

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, ACSTAR's statutory capital and surplus was $28,773,474 and $28,478,050 at December 31, 2012 and 2011 respectively, and its statutory net income for the years ended December 31, 2012 and 2011 was $2,371,975 and $2,296,113, respectively. The primary differences between amounts reported in accordance with GAAP and amounts reported in accordance with statutory accounting practices are the carrying value of fixed maturity investments; deferred taxes; the inadmissibility of certain assets for statutory reporting purposes; and the deferred recognition of policy acquisition costs in earnings.

### (10) Earnings Per Share

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the years ended December 31, 2012 and 2011:

| | | Net Earnings | Weighted Average Shares Outstanding | Per Share Amount |
|---|---|---|---|---|
| **2012** | | | | |
| Basic earnings per share | $ | 1,210,532 | 1,317,167 | 0.92 |
| Effect of dilutive securities: | | | | |
| Stock options | | | 63,865 | (0.04) |
| Diluted earnings per share | $ | 1,210,532 | 1,381,032 | 0.88 |

| | | Net Earnings | Weighted Average Shares Outstanding | Per Share Amount |
|---|---|---|---|---|
| **2011** | | | | |
| Basic earnings per share | $ | 1,233,676 | 1,367,201 | 0.90 |
| Effect of dilutive securities: | | | | |
| Stock options | | | 107,547 | (0.06) |
| Diluted earnings per share | $ | 1,233,676 | 1,474,748 | 0.84 |

### (11) Share 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 typically feature 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 weighted average exercise price of the outstanding options was $12.64 for the year ended December 31, 2012. The Company incurred no expense or corresponding tax benefit related to share based compensation in 2012. Total share based compensation expense totaled $3,816 for the year ended December 31, 2011 and resulted in a corresponding tax benefit of $1,297.

As of December 31, 2012 there were 126,500 stock options outstanding of which all were vested.

The following table shows the stock option activity for the Company during 2012 and 2011.

| | Option Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Average Intrinsic Value |
|---|---|---|---|---|
| Outstanding at December 31, 2010 | 290,500 | $10.97 | 2.8 | $1,425,484 |
| **2011** | | | | |
| Granted | - | - | | - |
| Exercised | - | - | | - |
| Cancelled | - | - | | - |
| Outstanding at December 31, 2011 | 290,500 | $ 10.97 | 1.8 | $1,425,484 |
| **2012** | | | | |
| Granted | - | - | | - |
| Exercised | 108,500 | $ 1.47 | | $ 532,409 |
| Cancelled | 55,500 | $ 0.20 | | $ 272,339 |
| Outstanding at December 31, 2012 | 126,500 | $ 12.64 | 1.9 | $ 620,736 |

Of the 126,500 outstanding options at December 31, 2012, all were exercisable.

The following table summarizes information about stock options outstanding at December 31, 2012:

| Range of Exercise Price | Options Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Grant Year | Options Exercisable |
|---|---|---|---|---|---|
| $11.40 | 20,000 | 1.2 | $11.40 | 2004 | 20,000 |
| $12.22 | 39,500 | 1.2 | $12.22 | 2004 | 39,500 |
| $13.25 | 67,000 | 2.5 | $13.25 | 2005 | 67,000 |
| $11.40 - $13.25 | 126,500 | 1.9 | $12.64 | | 126,500 |

## (12) 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.

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.

### (13) Leases

In February 2011 the Company sold its predecessor office building, at which time it entered into a non-cancellable operating lease for the then occupied office space. The sale and subsequent lease-back of the property did not qualify for the provisions of sale lease-back accounting given that no gain was recognized on the transaction. The lease features a two year term, expiring February 2013, and an annual rent of $389,844 payable in equal monthly installments. The conditions of the lease agreement prohibit the Company from sub-leasing unused office space and includes an escalation clause which began in 2012. Rental expense associated with this lease for the years ended December 31, 2012 and 2011 was $389,844 and $331,275, respectively.

Future minimum lease payments under the lease as of December 31, 2012 are:

| | | |
|---|---|---|
| Year ending December 31: | | |
| 2013 | $ | 64,974 |
| Total minimum lease payments | $ | 64,974 |

### (14) Subsequent Events

In April 2013 the Company obtained a mortgage note for $1.5 million in connection with the completion of a new headquarters in Farmington, CT. The note features a 10 year term and bears interest at a fixed rate of 3.47% for the first five years and resets thereafter.

There were no other subsequent events requiring adjustment to the consolidated financial statements or disclosure through April 25, 2013, the date the Company's consolidated financial statements were issued.

## Our Services

### 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.

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | High | Low | High | Low |
| Common Stock | | | | |
| First quarter | $ 24.50 | $ 24.50 | $ 25.00 | $ 25.00 |
| Second quarter | $ 34.00 | $ 24.50 | $ 25.26 | $ 25.00 |
| Third quarter | $ 34.00 | $ 34.00 | $ 25.26 | $ 24.50 |
| Fourth quarter | $ 34.00 | $ 20.75 | $ 24.50 | $ 24.50 |
| Class A Stock | | | | |
| First quarter | $ 25.30 | $ 23.15 | $ 26.00 | $ 24.75 |
| Second quarter | $ 23.85 | $ 22.25 | $ 25.60 | $ 24.77 |
| Third quarter | $ 23.60 | $ 19.00 | $ 25.75 | $ 24.95 |
| Fourth quarter | $ 22.00 | $ 18.25 | $ 25.00 | $ 24.10 |

### Annual Meeting

The annual meeting of stockholders will be held on June 27, 2013 at 12:00 P.M at 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 12, 2013 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**
*Executive Vice President*
*& Secretary*

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

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

OFFICERS

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

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

**Brian P. Marshall, CPA**
*Vice President of Finance*

**Maurice C. Shea**
*Controller*

**Gary M. Case, Esq.**
*Vice President & General Counsel*

ACSTAR Insurance Company

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

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

**Brian P. Marshall, CPA**
*Vice President of Finance*

**Carmen Carlton**
*Assistant Vice President*

**Gary M. Case, Esq.**
*Vice President & General Counsel*

**INDEPENDENT AUDITORS' REPORT**

The Board of Directors
ACMAT Corporation:

We have audited the accompanying consolidated financial statements of ACMAT Corporation and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of earnings, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

***Auditors' Responsibility***

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***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, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

**/s/ KPMG LLP**

Hartford, Connecticut
April 25, 2013

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SUBSIDIARY COMPANIES
ACSTAR Insurance Company
ACMAT Realty Corporation
AMINS, Inc.