

A black and white photograph of a person running on a grassy hill. The person is in the lower left corner, running towards the right. The sky is filled with large, dramatic clouds. A large, semi-transparent rectangular area with a fine grid pattern covers the center of the image, serving as a background for the text.

A PATH LESS TRAVELED

ACMAT CORPORATION ANNUAL REPORT 2011

A PATH LESS TRAVELED

Although “experts” predicted a rebound for the construction industry, 2011 turned out to be more disappointing than the preceding year. In spite of the challenging conditions, however, ACMAT and its subsidiary, ACSTAR, fared very well.

Our financial strength speaks for itself. Our progress is ongoing, even though the economy has yet to fully recover.

As we have in the past, we will adapt to change in the coming years. We will persevere. We will keep looking forward. Above all, we will follow our own path in the never-ending pursuit of success.

TO OUR SHAREHOLDERS AND CUSTOMERS:

During 2011 we continued to demonstrate our resiliency and our ability to prosper in the face of the continuing obstinance of the recession, especially considering the current plight of the construction industry.

Through our subsidiary, ACSTAR Insurance Company, we primarily provide bonds for all types of construction projects throughout the United States. We also provide surety bonds for other types of obligations. The U.S. construction industry has been severely impacted by the recession. Construction put in place has been in a free fall since 2006, dropping from \$1.2 trillion to just \$787 billion in 2011.

As expected, earned premium has declined in 2011 to \$2.6 million from \$3.2 million in 2010. Total revenue was \$6.4 million in 2011 vs. \$8.0 million in 2010. As we have done before, during 2011 we adapted to the circumstances and changed to fit the times. As a consequence, we emerged from 2011 with strong income of \$1.2 million up from \$941 thousand in 2010. Basic earnings per share increased to \$0.88 in 2011 up from \$0.69 in 2010. Overhead was reduced to \$3.3 million in 2011 from \$4.7 million in 2010. Long term debt was reduced to \$7.1 million at December 31, 2011 down from \$8.6 million at December 31, 2010. Shareholder equity increased to \$40.9 million at December 31, 2011 up from \$40.5 million at December 31, 2010. Our loss and loss adjustment expense during 2011 was exceptional, 11%.

In short, 2011 was a year of substantial progression.

Despite the paucity of good news for the immediate prospects for the construction industry, we believe the industry is approaching a point where the beginning of a recovery is in sight. Our guess is sometime between 2013 to 2015. Meanwhile, we have done well during this difficult

time. And barring any surprise, 2012 should be profitable, but most likely, too early to see any growth. We believe the strength of our earnings stems from our unusual approach to the market we serve. We provide surety bonds to an under served segment of the construction industry – contractors that cannot meet the underwriting requirements to gain surety credit from the major U.S. insurance companies, such as Travelers, Liberty Mutual, Zurich, CNA, Chubb and others. Usually after receiving a series of declinations, we work with such clients to find a way to provide surety credit. We utilize special and uncommon techniques to create surety credit designed around tailored terms structured to be feasible while allowing us to partially hedge our exposure. We concentrate on service, creativity and accessibility. Those who need bonds are also faced with the condition of providing a bond that will be acceptable to those who require the bonds, such as municipal, state and federal agencies, financial institutions, private owners and others. ACSTAR is a widely accepted issuer of bonds because of our excellent regulatory credentials, including being licensed in all 50 states, maintaining an A.M. Best Company rating of A, and being approved by the U.S. Department of the Treasury to write surety bonds to the United States of America. We believe our experience and unique underwriting skills and market credentials amount to a franchise of sort, difficult to duplicate. As and when the construction industry recovers, we believe we could substantially grow our surety business.

Our investment business is a source of revenue and income. Interest rates most likely will increase if and when the general economy recovers. During 2011, our investment income was \$2.6 million vs. \$2.9 million in 2010. Net realized capital gains were \$1.0 million in 2011 vs. \$1.2 million in 2010. Generally, our investment strategy is conservative. For example, approximately 56% of the investment portfolio is invested in either direct obligations

of the United States government, government sponsored agencies or state and municipal bonds. At December 31, 2011, approximately 12% of the portfolio was invested in common stocks, which in the last few years has generated capital gains. We've been lucky. Overall, we do not have a predilection for high risk.

In February 2011, we sold our corporate headquarters building in New Britain, CT and signed a two year lease for the current space we occupy. In October 2011, we broke ground for the construction of our new corporate headquarters building in Farmington, CT. During 2012, we will complete construction and move our offices to the new building. We expect the annual expense for the new building will be less than the annual (net of rent) expenses of the New Britain facility. Therefore, we will realize additional savings in overhead. The new complex will be a state-of-the-art, Class A facility.

We are considering the possible purchase, redevelopment and resale of targeted distressed commercial real estate if we are able to purchase such properties at bargain prices.

As with most enterprises, we face risks. For example, we often rely on bank letters of credit to partially securitize the high risk associated with writing surety bonds. A financial industry melt down could lead to possible bank defaults on letters of credit, which could result in greater exposure to contractor 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 tort 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.

The company has been purchasing its class A and common shares for more than 25 years. During 2011, we did not purchase any shares of the company's class A or common stock. We expect to make purchases during 2012, which could be considerable, provided pricing is mutually agreeable and the company has sufficient cash.

Again, we accomplished our operating plan and goal, which is to continue to increase per share equity. Per share equity increased from \$29.62 at December 31, 2010 to \$29.94 at December 31, 2011.

Because of the currency of our credentials, and the effectiveness of our underwriting and the strength of our investment assets, we look ahead to 2012 and beyond with confidence and optimism.

We wholeheartedly thank our customers and employees and our shareholders for their loyalty and support.



Henry W. Nozko, Jr.

Chairman, President
& Chief Executive Officer

May 10, 2012



From the beginning, ACMAT Corporation has demonstrated its ability to prosper by adapting to changing times and new opportunities. The past year was no exception.

Despite continued declines in the construction industry, our subsidiary, ACSTAR Insurance Company, continued to prosper in 2011. Our approach to the surety business has always set us apart from the “giants” of the industry. Typically, we provide bonds to those in the construction industry that are unable to meet the underwriting requirements of “traditional” bond issuers. We are not limited by underwriting “by the book.” And, we have never shied away from taking on challenging cases. As a result, we have forged a unique identity and become an important resource for the construction industry and other industries that require surety bonds.

By being creative, accessible and responsive to our clients, we have earned their respect. By being flexible, we have taken advantage of new opportunities as they’ve been presented to us. And by following our own path, we have remained strong where others have faltered.

A low-angle, black and white photograph of several skyscrapers reaching towards the sky. The perspective is from the ground looking up, creating a sense of height and scale. The buildings have various architectural styles, including grid-like window patterns and curved facades. The sky is a uniform light gray.

THE STORY BEHIND THE SKYLINE

Every day, ACSTAR Insurance Company plays a key role in shaping the infrastructure of cities and other communities throughout America. We provide surety bonds to support the performance and completion of construction (and renovation) of office buildings, retail centers, hospitals, hotels and other facilities. We also issue bonds to underwrite the construction or rehabilitation of roads, highways, bridges and other structures all across the nation. In many ways, "the story behind the skyline" is ACSTAR's story.

ACSTAR Insurance Company is certified by the United States Department of the Treasury to underwrite Federal bond obligations. ACSTAR is rated A VI by A.M. Best Company and is licensed in all 50 states.



BRINGING FAMILIES TOGETHER ACROSS A POLITICAL DIVIDE

Only 90 miles of ocean separate the United States and the Republic of Cuba. But long-standing political differences have made the gulf between the two countries seemingly insurmountable. In fact, the U.S. government has had an embargo on travel to Cuba since the early '60s. You cannot simply "book a flight" to Cuba. Travel is permitted only under certain conditions. You are only allowed to travel to Cuba from the U.S. if you are a Cuban-American visiting family there, a journalist, a "professional" or academic doing research, or on a religious or humanitarian mission. Further, the U.S. federal government licenses only a limited number of providers of public charter flights. These flights can only depart from selected locations, such as Miami, Florida. A surety bond to the U.S. Department of Transportation must be issued for every single authorized flight to Cuba. For several years, ACSTAR has provided more than \$3 million in open bonds each year to facilitate a steady flow of flights and help families (and others) overcome the divide of politics.

WHEN THE WATER DANCES

When you see a spectacular water feature – a waterfall, wall, fountain, floating object and more – there's a chance that ACSTAR Insurance Company has played a role in making it possible.

ACSTAR issues bonds for Kusser FountainWorks, a division of a 100-year-old, family-owned German company. Kusser FountainWorks is recognized worldwide for the quality, precision and reliability of its water features.

Using pre-engineered natural stone components cut to precise tolerances, advanced mechanical and electrical components, plus exclusive designs that eliminate the need for structural concrete (except for foundation beams), Kusser offers its clients turnkey installation of spectacular water features – many valued at \$1 million or more – in 30 days or less.

So when you see children dodging unpredictable spurts of water in a public park, a rock sphere that appears to float on a perfectly smooth water table, an endless waterfall that cascades down the interior wall of a hospital, or a stunning display of jets that seem to dance in time to music, think ACSTAR.



ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Earnings — Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|--|---------------------|----------------|
| Earned premiums | \$ 2,626,593 | 3,222,050 |
| Contract revenues | --- | 20,787 |
| Investment income, net | 2,627,007 | 2,873,976 |
| Net realized capital gains | 995,071 | 1,174,081 |
| Other income | <u>198,873</u> | <u>772,191</u> |
| | 6,447,544 | 8,063,085 |
| Cost of contract revenues | --- | 97,080 |
| Losses and loss adjustment expenses | 286,904 | 366,884 |
| Amortization of policy acquisition costs | 1,061,434 | 1,075,243 |
| General and administrative expenses | 3,293,440 | 4,660,274 |
| Impairment loss on building | --- | 401,624 |
| Interest expense | <u>263,209</u> | <u>304,253</u> |
| | 4,904,987 | 6,905,358 |
| Earnings before income taxes | 1,542,557 | 1,157,727 |
| Income taxes | <u>340,746</u> | <u>217,034</u> |
| Net earnings | <u>\$ 1,201,811</u> | <u>940,693</u> |
| Basic earnings per share | \$ 0.88 | 0.69 |
| Diluted earnings per share | \$ 0.81 | 0.64 |

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheets — December 31, 2011 and 2010

| | 2011 | 2010 |
|--|----------------------|--------------------|
| Assets | | |
| Investments: | | |
| Fixed maturities — available for sale (Amortized cost of \$57,470,706 in 2011 and \$68,673,253 in 2010) | \$ 58,507,044 | 69,091,471 |
| Equity securities — available for sale (Cost of \$12,439,035 in 2011 and \$5,320,369 in 2010) | 11,255,244 | 5,858,523 |
| Short-term investments, at cost which approximates fair value | <u>6,654,516</u> | <u>5,625,451</u> |
| Total Investments | 76,416,804 | 80,575,445 |
| Cash and cash equivalents | 9,968,438 | 7,058,631 |
| Accrued interest receivable | 500,296 | 662,445 |
| Receivables, net of allowance for doubtful accounts of \$48,266 in 2011 and 2010 | 921,785 | 786,082 |
| Reinsurance recoverable: | | |
| Unpaid losses | 2,743,081 | 3,718,182 |
| Paid losses | 32,347 | 36,492 |
| Prepaid expenses | 71,716 | 76,435 |
| Income taxes receivable | 1,015,135 | 179,297 |
| Deferred income taxes | 987,893 | 1,808,332 |
| Property and equipment, net | 1,617,923 | 3,635,467 |
| Deferred policy acquisition costs | 542,330 | 508,850 |
| Other assets | 943,139 | 897,479 |
| Intangibles | <u>1,920,360</u> | <u>1,920,360</u> |
| Total Assets | <u>\$ 97,681,247</u> | <u>101,863,497</u> |
| Liabilities and Stockholders' Equity | | |
| Accounts payable | \$ 616,707 | 377,964 |
| Reserves for losses and loss adjustment expenses | 17,506,782 | 20,157,801 |
| Unearned premiums | 1,241,007 | 1,270,749 |
| Collateral held | 28,500,822 | 29,203,374 |
| Other accrued liabilities | 1,737,977 | 1,789,445 |
| Long-term debt | <u>7,142,857</u> | <u>8,571,429</u> |
| Total Liabilities | 56,746,152 | 61,370,762 |
| Stockholders' Equity: | | |
| Common Stock (No par value; 3,500,000 shares authorized; 468,546 and 468,546 shares issued and outstanding) | 468,546 | 468,546 |
| Class A Stock (No par value; 10,000,000 shares authorized; 898,655 and 898,655 shares issued and outstanding) | 898,655 | 898,655 |
| Retained earnings | 39,665,428 | 38,459,801 |
| Accumulated other comprehensive (loss) income | <u>(97,534)</u> | <u>665,733</u> |
| Total Stockholders' Equity | <u>40,935,095</u> | <u>40,492,735</u> |
| Total Liabilities and Stockholders' Equity | <u>\$ 97,681,247</u> | <u>101,863,497</u> |

See Notes to Consolidated Financial Statements.

| | Common <u>Stock par value</u> | Class A Stock <u>par value</u> | Retained <u>earnings</u> | Accumulated other comprehensive <u>(loss) income</u> | Total stockholders' <u>equity</u> |
|--|----------------------------------|-----------------------------------|-----------------------------|---|---|
| Balance as of December 31, 2009 | \$468,546 | 898,655 | 37,502,210 | 257,846 | 39,127,257 |
| Comprehensive income: | | | | | |
| Net unrealized gains on debt and equity securities, net of reclassification adjustment and income taxes | \$ --- | --- | --- | 407,887 | 407,887 |
| Net earnings | --- | --- | 940,693 | --- | 940,693 |
| Total comprehensive income | | | | | 1,348,580 |
| Stock-based compensation | --- | --- | 16,898 | --- | 16,898 |
| Balance as of December 31, 2010 | <u>\$ 468,546</u> | <u>898,655</u> | <u>38,459,801</u> | <u>665,733</u> | <u>40,492,735</u> |
| Comprehensive income: | | | | | |
| Net unrealized losses on debt and equity securities, net of reclassification adjustment and income taxes | \$ --- | --- | --- | (763,267) | (763,267) |
| Net earnings | --- | --- | 1,201,811 | --- | 1,201,811 |
| Total comprehensive income | | | | | 438,544 |
| Stock-based compensation | --- | --- | 3,816 | --- | 3,816 |
| Balance as of December 31, 2011 | <u>\$ 468,546</u> | <u>898,655</u> | <u>39,665,428</u> | <u>(97,534)</u> | <u>40,935,095</u> |

See Notes to Consolidated Financial Statements.

ACMAT CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows — Years Ended December 31, 2011 and 2010

| | <u>2011</u> | <u>2010</u> |
|---|---------------------|--------------------|
| Cash Flows From Operating Activities: | | |
| Net earnings | \$ 1,201,811 | 940,693 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Impairment loss on building and lease | --- | 401,624 |
| Stock-based compensation | 3,816 | 16,898 |
| Depreciation and amortization | 595,218 | 1,325,337 |
| Net realized capital gains | (995,071) | (1,174,081) |
| Deferred income tax expense (benefit) | 1,198,153 | (170,758) |
| Changes In: | | |
| Accrued interest receivable | 162,149 | 18,135 |
| Receivables | (135,703) | (218,561) |
| Reinsurance recoverable | 979,246 | (111,991) |
| Deferred policy acquisition costs | (33,480) | 80,604 |
| Prepaid expenses and other assets | (41,830) | 20,203 |
| Accounts payable and other liabilities | 187,275 | (39,788) |
| Collateral held | (702,552) | (2,161,322) |
| Reserves for losses and loss adjustment expenses | (2,651,019) | (1,439,945) |
| Income taxes | (835,838) | (8,910) |
| Unearned premiums | (29,742) | (376,954) |
| Net cash used for operating activities | <u>(1,097,567)</u> | <u>(2,898,816)</u> |
| Cash Flows From Investing Activities: | | |
| Proceeds from investments sold, matured or redeemed: | | |
| Fixed maturities sold | 3,374,646 | 19,597,038 |
| Fixed maturities matured or redeemed | 19,530,335 | 16,137,425 |
| Equity securities | 29,634,291 | 3,593,066 |
| Purchases of: | | |
| Fixed maturities | (12,416,731) | (28,941,970) |
| Equity securities | (35,608,583) | (6,235,177) |
| Short-term investment purchases, net | (1,029,065) | (2,189,100) |
| Net proceeds from disposition of occupied office building | 2,716,000 | --- |
| Capital expenditures | (764,947) | (650,219) |
| Net cash provided by investing activities | <u>5,435,946</u> | <u>1,311,063</u> |
| Cash Flows From Financing Activities: | | |
| Repayments on long-term debt | (1,428,572) | (1,428,571) |
| Net cash used for financing activities | <u>(1,428,572)</u> | <u>(1,428,571)</u> |
| Net change in cash and cash equivalents | 2,909,807 | (3,016,324) |
| Cash and cash equivalents, beginning of year | <u>7,058,631</u> | <u>10,074,955</u> |
| Cash and cash equivalents, end of year | \$ <u>9,968,438</u> | <u>7,058,631</u> |

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — December 31, 2011 and 2010

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The consolidated financial statements include ACMAT Corporation ("ACMAT" or the "Company"), and its subsidiaries, including 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

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.

ACSTAR Bonding 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 historically provided construction contracting services to commercial and governmental customers. During 2009, the Company discontinued performing construction work. ACMAT Contracting also provides underwriting services to its insurance affiliate and is currently constructing an office building through which it is expected to earn rental income from its insurance affiliate. ACMAT Contracting owned a commercial office building in New Britain, Connecticut through 2010 and leased office space to its insurance affiliate as well as to third parties. The Company sold the office building during the year.

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

An investment in a debt or equity security is other-than-temporarily impaired if its 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 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, 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 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 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 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 certain underwriting costs, are deferred and amortized pro rata over the contract periods in which the related premiums are earned. Deferred acquisition costs are reviewed to determine if they are recoverable from future income, and if not, are charged to expense. Future investment income attributable to related premiums is taken into account in measuring the recoverability of the carrying value of this asset.

(e) Property and Equipment

Property and equipment are stated at cost net of depreciation. Depreciation is computed using the straight-line method 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) 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 of what, at any given point in time, 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 and investments retained by the Company for surety bonds issued by the Company to cover costs of claims or unpaid premiums. The carrying amount of collateral held approximates its fair value because of the short maturity of these instruments.

(i) Reinsurance

In the normal course of business, the Company may assume and cede reinsurance with other companies. Reinsurance ceded primarily represents excess of loss reinsurance with companies with "A" ratings from the insurance rating organization, A.M. Best Company, Inc. Reinsurance ceded also includes a facultative reinsurance treaty which is applicable to excess policies written over a primary policy issued by the Company for specific projects.

Reinsurance is ceded to limit losses from large exposures and to permit recovery of a portion of direct losses; however, such a transfer does not relieve the originating insurer of its liability.

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

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

Reinsurance recoverables include ceded reserves for losses and loss adjustment expenses. Ceded unearned premiums of \$141,717 and \$150,808 at December 31, 2011 and 2010 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:

| | Premiums Written | | Premiums Earned | |
|---------|---------------------|------------------|---------------------|------------------|
| | 2011 | 2010 | 2011 | 2010 |
| Direct | \$ 3,053,108 | 3,405,052 | \$ 3,082,850 | 3,782,006 |
| Assumed | --- | --- | --- | --- |
| Ceded | (447,166) | (499,508) | (456,257) | (559,956) |
| Net | <u>\$ 2,605,942</u> | <u>2,905,544</u> | <u>\$ 2,626,593</u> | <u>3,222,050</u> |

Ceded incurred losses and loss adjustment expenses totaled \$57,248 and \$63,761 for the years ended December 31, 2011 and 2010, 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.

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.

(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 and the related tax effects for the years ended December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---------------------|----------------|
| Unrealized holding (loss) gain arising during period, net of income taxes | \$ (106,520) | 1,182,780 |
| Less reclassification adjustment for gains included in net earnings, net of income tax expense of \$338,324 in 2011 and \$399,188 in 2010 | <u>656,747</u> | <u>774,893</u> |
| Other comprehensive (loss) income | <u>\$ (763,267)</u> | <u>407,887</u> |

(n) Stock – Based Compensation

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

(o) Accounting Standards

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 is effective for the quarter ending March 31, 2012 and is not expected to have a material effect on the Company's results of operations, financial position and liquidity.

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 ending March 31, 2012. Early adoption is permitted. The updated guidance will result in a change in the presentation of the Company's consolidated financial statements but will not have any impact on the Company's results of operations, financial position or liquidity.

(2) Investments

Fixed maturities at December 31, 2011 and 2010 are as follows:

| | Amortized Cost | Gross Unrealized Gains | Losses | Fair Value |
|---|---------------------|---------------------------|------------------|-------------------|
| 2011 | | | | |
| Fixed maturities: | | | | |
| States, municipalities and political subdivisions | \$22,171,109 | 920,746 | (34,789) | 23,057,066 |
| United States government and government agencies | 4,022,322 | 8,201 | --- | 4,030,523 |
| Mortgage-backed securities | 20,634,640 | 535,473 | (339,240) | 20,830,873 |
| Industrial and miscellaneous | 8,995,435 | 147,027 | (132,791) | 9,009,671 |
| Redeemable preferred stock | <u>1,647,200</u> | <u>28,436</u> | <u>(96,725)</u> | <u>1,578,911</u> |
| Total fixed maturities | <u>\$57,470,706</u> | <u>1,639,883</u> | <u>(603,545)</u> | <u>58,507,044</u> |
| 2010 | | | | |
| Fixed maturities: | | | | |
| States, municipalities and political subdivisions | \$23,445,912 | 248,005 | (304,470) | 23,389,447 |
| United States government and government agencies | 4,105,455 | 30,959 | (254) | 4,136,160 |
| Mortgage-backed securities | 27,231,262 | 564,576 | (223,043) | 27,572,795 |
| Industrial and miscellaneous | 12,407,424 | 253,570 | (70,523) | 12,590,471 |
| Redeemable preferred stock | <u>1,447,200</u> | <u>6,513</u> | <u>(51,115)</u> | <u>1,402,598</u> |
| Total fixed maturities | <u>\$68,637,253</u> | <u>1,103,623</u> | <u>(649,405)</u> | <u>69,091,471</u> |

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.

| | 2011 Amortized Cost | Fair Value |
|--|---------------------------|-------------------|
| Due in one year or less | \$ 8,041,023 | 8,069,588 |
| Due after one year through five years | 13,424,995 | 13,753,176 |
| Due after five years through ten years | 8,872,658 | 9,115,685 |
| Due after ten years | 6,497,390 | 6,737,722 |
| Mortgage-backed securities | <u>20,634,640</u> | <u>20,830,873</u> |
| Total | <u>\$57,470,706</u> | <u>58,507,044</u> |

At December 31, 2011 and 2010, the Company held mortgage-backed securities with a fair value of \$20,830,873 and \$27,572,795, respectively. Approximately 79% and 81% 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, 2011 and 2010, 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 \$13,976,802 and \$21,492,708, 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 (either shortening or lengthening of duration) and its effect on total return cannot be fully controlled, particularly when interest rates move dramatically, the investment process generally favors securities that control this risk within expected interest rate ranges. The Company does invest in other types of CMO tranches if a careful assessment indicates a favorable risk/return tradeoff. The Company does not purchase residual interests in CMOs. Approximately 70% and 81% of the Company's CMO holdings are fully collateralized by GNMA, FNMA, SBA, or FHLMC securities at December 31, 2011 and 2010, respectively.

Proceeds from sales of fixed maturities classified as available for sale were \$3,374,646 and \$19,597,038 in 2011 and 2010, respectively. Gross gains of \$80,785 and \$812,902 and gross losses of \$230,089 and \$58,498 were realized on fixed maturity sales for the years ended December 31, 2011 and 2010, respectively.

At December 31, 2011 and 2010, the Company's insurance subsidiary had securities with an aggregate fair value of \$4,030,523 and \$4,136,160, respectively, on deposit with various state regulatory authorities.

Equity securities at December 31, 2011 and 2010 are as follows:

| | Gross Unrealized Cost | Gains | Losses | Fair Value |
|------------------------------|--------------------------|----------------|--------------------|-------------------|
| 2011 | | | | |
| Common stocks: | | | | |
| Industrial and miscellaneous | \$10,211,158 | 551,843 | (1,531,917) | 9,231,084 |
| Perpetual preferred stocks: | | | | |
| Industrial and miscellaneous | <u>2,227,877</u> | <u>77,423</u> | <u>(281,140)</u> | <u>2,024,160</u> |
| Total Equity Securities | <u>12,439,035</u> | <u>629,266</u> | <u>(1,813,057)</u> | <u>11,255,244</u> |
| 2010 | | | | |
| Common stocks: | | | | |
| Industrial and miscellaneous | \$ 3,953,969 | 749,756 | (156,622) | 4,547,103 |
| Perpetual preferred stocks: | | | | |
| Industrial and miscellaneous | <u>1,366,400</u> | <u>34,940</u> | <u>(89,920)</u> | <u>1,311,420</u> |
| Total equity securities | <u>\$ 5,320,369</u> | <u>784,696</u> | <u>(246,542)</u> | <u>5,858,523</u> |

Proceeds from sales of equity securities were \$29,634,291 and \$3,593,066 in 2011 and 2010, respectively. Gross gains of \$1,414,407 and \$733,489 were realized on the sale of equity securities for the years ended December 31, 2011 and 2010, respectively, and gross losses of \$270,032 and \$313,810 were realized on the sale of equity securities for the years ended December 31, 2011 and 2010, respectively.

ACMAT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — December 31, 2011 and 2010

The following tables summarize, for all investments in an unrealized loss position at December 31, 2011 and 2010, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position, were as follows:

| | <u>Less than 12 months</u> | | <u>12 months or longer</u> | | <u>Total 2011</u> | |
|---|----------------------------|------------------------------|----------------------------|------------------------------|-------------------|------------------------------|
| | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> |
| Fixed maturities: | | | | | | |
| States, municipalities and political subdivisions | \$60,431 | 605 | 1,807,325 | 34,184 | 1,867,756 | 34,789 |
| Mortgage-backed securities | 6,059,765 | 234,085 | 498,060 | 105,155 | 6,557,825 | 339,240 |
| Industrial and miscellaneous | 2,968,268 | 132,791 | --- | --- | 2,968,268 | 132,791 |
| Redeemable preferred stock | --- | --- | <u>390,775</u> | <u>96,725</u> | <u>390,775</u> | <u>96,725</u> |
| Total fixed maturities | 9,088,464 | 367,481 | 2,696,160 | 236,064 | 11,784,624 | 603,545 |
| Equity securities – common stocks | 4,877,388 | 1,359,792 | 688,400 | 172,125 | 5,565,788 | 1,531,917 |
| Equity securities – perpetual preferred | <u>137,000</u> | <u>63,000</u> | <u>523,260</u> | <u>218,140</u> | <u>660,260</u> | <u>281,140</u> |
| Total equity securities | <u>5,014,388</u> | <u>1,422,792</u> | <u>1,211,660</u> | <u>390,265</u> | <u>6,226,048</u> | <u>1,813,057</u> |
| Total | <u>\$14,102,852</u> | <u>1,790,273</u> | <u>3,907,820</u> | <u>626,329</u> | <u>18,010,672</u> | <u>2,416,602</u> |

| | <u>Less than 12 months</u> | | <u>12 months or longer</u> | | <u>Total 2010</u> | |
|---|----------------------------|------------------------------|----------------------------|------------------------------|-------------------|------------------------------|
| | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> | <u>Fair Value</u> | <u>Gross Unrealized Loss</u> |
| Fixed maturities: | | | | | | |
| States, municipalities and political subdivisions | \$11,040,794 | 286,812 | 1,256,255 | 17,658 | 12,297,049 | 304,470 |
| United States government and government agencies | 276,623 | 254 | --- | --- | 276,623 | 254 |
| Mortgage-backed securities | 4,547,205 | 59,348 | 1,472,984 | 163,695 | 6,020,189 | 223,043 |
| Industrial and miscellaneous | 3,549,408 | 70,523 | --- | --- | 3,549,408 | 70,523 |
| Redeemable preferred stock | --- | --- | <u>973,935</u> | <u>51,115</u> | <u>973,935</u> | <u>51,115</u> |
| Total fixed maturities | 19,414,030 | 416,937 | 3,703,174 | 232,468 | 23,117,204 | 649,405 |
| Equity securities – common stocks | 896,900 | 156,622 | --- | --- | 896,900 | 156,622 |
| Equity securities – perpetual preferred | --- | --- | <u>651,480</u> | <u>89,920</u> | <u>651,480</u> | <u>89,920</u> |
| Total equity securities | <u>896,900</u> | <u>156,222</u> | <u>651,480</u> | <u>89,920</u> | <u>1,548,380</u> | <u>246,542</u> |
| Total | <u>\$20,310,930</u> | <u>573,559</u> | <u>4,354,654</u> | <u>322,388</u> | <u>24,665,584</u> | <u>895,947</u> |

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, 2011, 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 <u>3 Months</u> | Greater Than 3 Months, Less Than <u>6 Months</u> | Greater Than 6 Months, Less Than <u>12 Months</u> | Greater Than <u>12 Months</u> | <u>Total</u> |
|------------------------------|------------------------------|---|--|----------------------------------|------------------|
| Fixed maturities: | | | | | |
| Mortgage-backed securities | \$ 111,117 | --- | --- | 70,750 | 181,867 |
| Industrial and miscellaneous | --- | 21,691 | --- | --- | 21,691 |
| Redeemable preferred stock | --- | <u>64,000</u> | --- | --- | <u>64,000</u> |
| Total fixed maturities | --- | 85,691 | --- | 70,750 | 267,558 |
| Equity securities | <u>158,600</u> | <u>1,363,365</u> | <u>42,998</u> | --- | <u>1,564,963</u> |
| Total | <u>\$ 269,717</u> | <u>1,449,056</u> | <u>42,988</u> | <u>70,750</u> | <u>1,832,521</u> |

Approximately 60% of the unrealized losses reported above relate to common stocks of domestic banks and financial institutions, which were subject to disruption in the capital markets throughout the later half of 2011 in response to the European debt crisis. Market prices have rebounded in early 2012 following a series of measures taken by European officials to ease financial pressures. Excluding the impact of these temporary declines in the fair value of the common stocks of banks and financial institutions, 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 less than 1% of shareholders' equity on an after-tax basis.

The following table summarizes fixed maturity securities in a gross unrealized loss position by investment category and by credit rating as of December 31, 2011. The table also discloses the corresponding count of securities in an unrealized position and estimated fair value by category:

| | <u>AAA</u> | <u>AA</u> | <u>A</u> | <u>BBB</u> | <u>Total</u> | <u>Estimated Fair Value</u> |
|---|------------------|---------------|---------------|---------------|----------------|-------------------------------------|
| Investment grade (a): | | | | | | |
| States, municipalities and political subdivisions (9) | \$ 15,038 | 18,381 | 1,370 | --- | 34,789 | 1,867,756 |
| Mortgage-backed securities (15) | 46,217 | 4,204 | 9,887 | 6,386 | 66,694 | 4,826,251 |
| Industrial and miscellaneous (3) | --- | --- | --- | <u>31,863</u> | <u>31,863</u> | <u>593,755</u> |
| Total investment grade | 61,255 | 22,585 | 11,257 | 38,249 | 133,346 | 7,287,762 |
| Non-investment grade: | | | | | | |
| Mortgage-backed securities (11) | --- | --- | --- | --- | 272,546 | 1,731,574 |
| Industrial and miscellaneous (12) | --- | --- | --- | --- | 100,928 | 2,374,513 |
| Redeemable preferred stock (3) | --- | --- | --- | --- | <u>96,725</u> | <u>390,775</u> |
| Total non-investment grade | --- | --- | --- | --- | <u>470,199</u> | <u>4,496,862</u> |
| Total | <u>\$ 61,255</u> | <u>22,585</u> | <u>11,257</u> | <u>38,249</u> | <u>603,545</u> | <u>11,784,624</u> |

(a) Securities are categorized using the Moody's rating. If a security is not rated by Moody's, the equivalent Standard & Poor's rating is used.

At December 31, 2011, the Company holds eleven non-investment grade CMO securities with an unrealized loss of \$272,546 and an amortized cost of \$1,731,574. The Company believes that the decline in fair value of these securities is the result of prepayments on the underlying mortgages, which shorten the duration of the security. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized loss on these securities is indicative of a credit loss and, as such, has not recognized an other-than-temporary impairment loss on these securities in 2011 or 2010.

Based on the current facts and circumstances discussed above and for the remainder of the Company's securities in an unrealized loss position, the Company has determined that no other-than-temporary impairment losses related to the securities in an unrealized loss position are required to be recorded at December 31, 2011.

A summary of net investment income for the years ended December 31, 2011 and 2010 follows:

| | <u>2011</u> | <u>2010</u> |
|--------------------------------|---------------------|------------------|
| Tax-exempt interest | \$ 627,615 | 517,644 |
| Taxable interest | 1,813,129 | 2,143,999 |
| Dividends on equity securities | 357,399 | 289,698 |
| Investment expenses | <u>(171,137)</u> | <u>(77,365)</u> |
| Net investment income | <u>\$ 2,627,007</u> | <u>2,873,976</u> |

(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, e.g., a forced transaction. Additionally, the valuation of fixed maturity investments is more subjective when markets are less liquid due to the lack of market based inputs, which may increase the

potential that the estimated fair value (i.e., the carrying amount) of an investment is not reflective of the price at which an actual transaction would occur.

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

Fixed Maturities

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

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

Equities

For 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 and financial liabilities are measured on a recurring basis at December 31, 2011 and 2010.

| <u>As of December 31, 2011:</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|---|---------------------|-------------------|----------------|-------------------|
| Fixed maturities: | | | | |
| States, municipalities and political subdivisions | \$ --- | 23,057,066 | --- | 23,057,066 |
| United States government and government agencies | 4,030,523 | --- | --- | 4,030,523 |
| Mortgage-backed securities | --- | 20,830,873 | --- | 20,830,873 |
| Industrial and miscellaneous | --- | 9,009,671 | --- | 9,009,671 |
| Redeemable preferred stock | --- | <u>1,578,911</u> | --- | <u>1,578,911</u> |
| Total fixed maturities | <u>\$4,030,523</u> | <u>54,476,521</u> | --- | <u>58,507,044</u> |
| Equity securities – common stocks | 9,231,084 | --- | --- | 9,231,084 |
| Equity securities – perpetual preferred | --- | <u>2,024,160</u> | --- | <u>2,024,160</u> |
| Total equity securities | <u>9,231,084</u> | <u>2,024,160</u> | --- | <u>11,255,244</u> |
| Short-term investments | --- | <u>6,654,516</u> | --- | <u>6,654,516</u> |
| Total | <u>\$13,261,607</u> | <u>63,155,197</u> | --- | <u>76,416,804</u> |

| <u>As of December 31, 2010:</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|---|--------------------|-------------------|----------------|-------------------|
| Fixed maturities: | | | | |
| States, municipalities and political subdivisions | \$ --- | 23,389,447 | --- | 23,389,447 |
| United States government and government agencies | 4,136,160 | --- | --- | 4,136,160 |
| Mortgage-backed securities | --- | 27,572,795 | --- | 27,572,795 |
| Industrial and miscellaneous | --- | 12,590,471 | --- | 12,590,471 |
| Redeemable preferred stock | --- | <u>1,402,598</u> | --- | <u>1,402,598</u> |
| Total fixed maturities | <u>\$4,136,160</u> | <u>64,955,311</u> | --- | <u>69,091,471</u> |
| Equity securities – common stocks | 4,547,103 | --- | --- | 4,547,103 |
| Equity securities – perpetual preferred | --- | <u>1,311,420</u> | --- | <u>1,311,420</u> |
| Total equity securities | <u>4,547,103</u> | <u>1,311,420</u> | --- | <u>5,858,523</u> |
| Short-term investments | --- | <u>5,625,451</u> | --- | <u>5,625,451</u> |
| Total | <u>\$8,681,263</u> | <u>71,892,182</u> | --- | <u>80,575,445</u> |

There were no significant transfers between Level 1 and 2 or from level 3 in 2011 or 2010.

(4) Receivables

A summary of receivables at December 31, 2011 and 2010 is as follows:

| | <u>2011</u> | <u>2010</u> |
|--|-------------------|-----------------|
| Insurance premiums due from agents | \$ 408,721 | 190,663 |
| Receivables under construction contracts | --- | 21,844 |
| Other | <u>561,331</u> | <u>621,841</u> |
| Total receivables | 970,052 | 834,348 |
| Less allowances for doubtful accounts | <u>(48,267)</u> | <u>(48,266)</u> |
| Total receivables, net | \$ <u>921,785</u> | <u>786,082</u> |

(5) Property and Equipment

A summary of property and equipment at December 31, 2011 and 2010 is as follows:

| | <u>2011</u> | <u>2010</u> |
|--|---------------------|------------------|
| Building | \$ --- | 17,057,772 |
| Land | 558,178 | 1,358,178 |
| Equipment and vehicles | 947,678 | 887,962 |
| Furniture and fixtures | <u>878,934</u> | <u>878,934</u> |
| | 2,384,790 | 20,182,846 |
| Less accumulated depreciation | 1,503,741 | 9,675,714 |
| Less impairment allowance on office building | --- | 6,886,172 |
| Construction work-in-progress | <u>736,874</u> | <u>14,507</u> |
| Property and equipment, net: | \$ <u>1,617,923</u> | <u>3,635,467</u> |

As a result of the Company's decision to sell its office building, the Company recognized aggregate impairment of \$6,886,172, of which \$401,624 was recognized during 2010. The building was subsequently sold in February 2011 for net proceeds of \$2,716,000. The transaction did not result in a realized gain or loss for book reporting purposes in 2011. Rental income earned in 2011 and 2010 was \$102,619 and \$675,850, respectively.

Useful lives for depreciation purposes are five years for equipment and vehicles, seven years for furniture and fixtures and forty years for the occupied office building. Depreciation expense in 2011 and 2010 was \$66,491 and \$546,823, 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>2011</u> | <u>2010</u> |
|------------------------------|----------------------|--------------------|
| Balance at January 1 | \$20,157,801 | 21,597,746 |
| Less reinsurance recoverable | <u>3,718,182</u> | <u>3,642,683</u> |
| Net balance at January 1 | 16,439,619 | 17,955,063 |
| Incurred related to: | | |
| Current year | 1,436,000 | 2,418,000 |
| Prior years | <u>(1,149,096)</u> | <u>(2,051,116)</u> |
| Total incurred | 286,904 | 366,884 |
| Payments related to: | | |
| Current year | 22,000 | 35,000 |
| Prior years | <u>1,940,822</u> | <u>1,847,328</u> |
| Total payments | 1,962,822 | 1,882,328 |
| Net balance at December 31 | 14,763,701 | 16,439,619 |
| Plus reinsurance recoverable | <u>2,743,081</u> | <u>3,718,182</u> |
| Balance at December 31 | \$ <u>17,506,782</u> | <u>20,157,801</u> |

The decrease in reserves for unpaid losses and loss adjustment expenses (LAE) in 2011 from 2010 primarily resulted from recovery of several claims offset in part by a decrease in claim payments in 2011. The decrease in incurred net loss and LAE for 2011 represents normal loss development on general liability and surety exposures in 2011 compared to more favorable loss development in 2010. 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.

ACMAT provides 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 insures asbestos and environmental exposures, which arise from 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. All environmental policies are written on a claims-made basis while asbestos liability is written on both claims-made and occurrence basis. The Company also provides pollution liability insurance on a claims-made basis for storage and treatment facilities, underground storage tanks, and other sites.

(7) Notes Payable to Banks

At December 31, 2011, the Company has a \$7,000,000 bank line of credit with a financial institution. The line of credit does not require the Company to maintain a compensating balance. There were no outstanding borrowings under this line of credit at December 31, 2011 and 2010. 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 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.

(8) Long-term Debt

A summary of long-term debt at December 31, 2011 and 2010 follows:

| | 2011 | 2010 |
|--------------------|--------------------|------------------|
| Term Loan due 2016 | <u>\$7,142,857</u> | <u>8,571,429</u> |

On December 23, 2009, the Company obtained a \$10,000,000 term loan from a financial institution, which is payable in monthly installments of \$119,048. The term loan, due 2016, has a balance of \$7,142,857 at December 31, 2011. The interest rate varies based on 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, 2011.

Principal payments on long-term debt are \$1,428,572 for each of the years 2012 through 2016. Interest expense paid in 2011 and 2010 amounted to \$263,209 and \$304,253, respectively. The carrying value of the term loan at December 31, 2011 approximates fair value.

(9) Income Taxes

The components of income tax expense for the years ended December 31, 2011 and 2010 were as follows:

| | 2011 | 2010 |
|-----------------|--------------------|------------------|
| Current Taxes: | | |
| Federal | (\$903,443) | 293,199 |
| State | <u>46,036</u> | <u>94,593</u> |
| | <u>(\$857,407)</u> | <u>387,792</u> |
| Deferred Taxes: | | |
| Federal | 1,198,153 | (170,758) |
| State | <u>---</u> | <u>---</u> |
| | <u>1,198,153</u> | <u>(170,758)</u> |
| Total | <u>\$ 340,746</u> | <u>217,034</u> |

The effective income tax rate, as a percentage of earnings before income taxes for the years ended December 31, 2011 and 2010 was as follows:

| | 2011 | 2010 |
|----------------------------|--------------|--------------|
| Federal statutory tax rate | 34.0% | 34.0% |
| State income tax | 2.0 | 5.4 |
| Tax exempt interest | (13.7) | (11.7) |
| Prior year effect | --- | (6.9) |
| Other, net | <u>(0.2)</u> | <u>(2.0)</u> |
| Effective income tax rate | <u>22.1%</u> | <u>18.8%</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, 2011 and 2010 are presented below:

| | 2011 | 2010 |
|--|--------------------|--------------------|
| Deferred Tax Assets: | | |
| Reserves for losses and loss adjustment expenses | \$ 360,619 | 369,747 |
| Unearned premiums | 74,752 | 76,156 |
| Allowance for doubtful accounts | 16,410 | 16,410 |
| Impairment Allowance on building | --- | 2,341,298 |
| Impairment Allowance on lease | 99,409 | 99,409 |
| Unrealized losses on investments | 50,066 | --- |
| Federal net operating loss carryforward | 481,689 | --- |
| State net operating loss carryforward | 1,411,685 | 1,300,840 |
| Stock based compensation | 147,821 | 146,523 |
| Other | <u>---</u> | <u>19,834</u> |
| Total gross deferred tax assets | 2,642,451 | 4,370,217 |
| Less valuation allowance | <u>(1,411,685)</u> | <u>(1,300,840)</u> |
| Net deferred tax assets | \$1,230,766 | 3,069,377 |
| Deferred Tax Liabilities: | | |
| Property and equipment | \$ 13,339 | 712,085 |
| Deferred policy acquisition costs | 184,392 | 173,009 |
| Discount on investments | 45,142 | 49,170 |
| Unrealized gains on investments | --- | 326,602 |
| Other | <u>---</u> | <u>179</u> |
| Total gross deferred tax liabilities | <u>242,873</u> | <u>1,261,045</u> |
| Net deferred tax assets | <u>\$ 987,893</u> | <u>1,808,332</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, 2011 and 2010.

The most significant component of the state gross deferred asset is the net operating loss carryforward for the State of Connecticut which amounted to \$28,233,709 as of December 31, 2011 which expires between 2020 through 2031. In 2011 and 2010, 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 of \$110,845 in the valuation allowance is due to the current tax loss generated by the Connecticut domiciled companies.

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.

Taxes paid were \$170,000 and \$396,701 for the years ended December 31, 2011 and 2010, respectively.

(10) Pension and Profit Sharing Plans

The Company maintains the ACMAT 401(k) plan for the benefit of non-union employees. The Company contributed \$80,000 to the ACMAT 401(k) Plan in both 2011 and 2010. Costs associated with operating the Plan are borne by the Company and were insignificant for each of the years ended December 31, 2011 and 2010.

(11) 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.

Under applicable insurance regulations, ACMAT's insurance subsidiary is restricted as to the amount of dividends it may pay, without the prior approval of any insurance department and is limited to \$2,847,805 in 2012.

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 \$28,478,050 and \$30,165,816 at December 31, 2011 and 2010 respectively, and their statutory net income for the years ended December 31, 2011 and 2010 was \$2,296,113 and \$2,733,246, 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.

(12) 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, 2011 and 2010:

| | <u>Earnings</u> | <u>Weighted Average Shares Outstanding</u> | <u>Per-Share Amount</u> |
|------------------------------------|--------------------|--|-----------------------------|
| 2011: | | | |
| Basic EPS: | | | |
| Earnings available to stockholders | \$ 1,201,811 | 1,367,201 | \$0.88 |
| Effect of Dilutive Securities: | | | |
| Stock options | --- | <u>107,547</u> | |
| Diluted EPS: | | | |
| Earnings available to stockholders | <u>\$1,201,811</u> | <u>1,474,748</u> | <u>\$0.81</u> |
| 2010: | | | |
| Basic EPS: | | | |
| Earnings available to stockholders | \$ 940,693 | 1,367,201 | \$0.69 |
| Effect of Dilutive Securities: | | | |
| Stock options | --- | <u>103,050</u> | |
| Diluted EPS: | | | |
| Earnings available to stockholders | <u>\$ 940,693</u> | <u>1,470,251</u> | <u>\$0.64</u> |

(13) Stock – Based Compensation

The Company periodically grants non-qualified stock options to officers and directors giving such individuals the right to purchase restricted shares of the Company's Common Stock and Class A Stock. The majority of the options outstanding to officers generally vest evenly over a five to ten year period and 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 \$10.97 for the year ended December 31, 2011. Total stock-based compensation expense totaled \$3,816 and \$16,898 for the year ended December 31, 2011 and 2010, respectively. The tax benefit recognized on stock-based compensation totaled \$1,297 and \$5,745 for the year ended December 31, 2011 and 2010, respectively.

As of December 31, 2011 there were 290,500 stock options outstanding of which all were vested.

The following table shows the stock option activity for the Company during 2011 and 2010.

| | Option Shares | Weighted average exercise price | Weighted average remaining contractual term (in years) | Aggregate intrinsic value |
|----------------------------------|------------------|--|---|---------------------------------|
| Outstanding at December 31, 2009 | 332,500 | \$10.75 | | |
| 2010 activity: | | | | |
| Granted | -- | | | |
| Exercised | -- | \$ -- | | |
| Canceled | (42,000) | | | |
| Outstanding at December 31, 2010 | <u>290,500</u> | \$10.97 | | |
| 2011 activity: | | | | |
| Granted | -- | | | |
| Exercised | -- | \$ -- | | |
| Canceled | -- | | | |
| Outstanding at December 31, 2011 | <u>290,500</u> | \$10.97 | 1.76 | \$1,425,484 |
| Exercisable at December 31, 2011 | <u>290,500</u> | \$10.97 | 1.76 | \$1,425,484 |

Of the 290,500 outstanding options at December 31, 2011, 290,500 were exercisable. During 2011 and 2010, officers and directors did not exercise stock options.

The following table summarizes information about stock options outstanding at December 31, 2011:

| Range of exercise price | Number Outstanding | Weighted average remaining contractual life | Weighted average exercise price | Grant Year | Number exercisable |
|-------------------------|--------------------|---|---------------------------------|------------|--------------------|
| \$ 9.00 | 134,000 | 0.47 | \$ 9.00 | 2002 | 134,000 |
| \$12.22 | 54,500 | 2.20 | \$12.22 | 2004 | 54,500 |
| \$11.40 | 20,000 | 2.20 | \$11.40 | 2004 | 20,000 |
| \$13.25 | <u>82,000</u> | 3.48 | \$13.25 | 2005 | <u>82,000</u> |
| \$9.00-13.25 | <u>290,500</u> | 1.76 | \$10.97 | | <u>290,500</u> |

(14) 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.

(15) Leasing

In February 2011 the Company sold its office building, at which time it entered into a noncancellable operating lease for the 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 subleasing unused office space and includes an escalation clause beginning in 2012. Rental expense associated with this lease for the year ended December 31, 2011 was \$331,275.

Future minimum lease payments under the lease as of December 31, 2011 are:

| | |
|------------------------------|-------------------|
| Year ending December 31: | |
| 2012 | \$ 389,844 |
| 2013 | <u>64,974</u> |
| Total minimum lease payments | <u>\$ 454,818</u> |

(16) Segment Reporting

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

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

ACMAT Contracting historically provided construction contracting services to commercial and governmental customers. During 2009, the Company discontinued performing construction work. ACMAT Contracting also provides underwriting services to its insurance affiliate and is currently constructing an office building through which it is expected to earn rental income from its insurance affiliate. ACMAT Contracting owned a commercial office building in New Britain, Connecticut through 2010 and leased office space to its insurance affiliate as well as to third parties. The Company sold the office building during the year.

The Company evaluates performance based on earnings before income taxes and excluding interest expense. The segments account for intercompany revenues and expenses as if the products/services were to third parties. Information relating to the two segments is summarized as follows:

| | 2011 | 2010 |
|--------------------------------|----------------------|--------------------|
| Revenues: | | |
| ACSTAR Bonding | \$ 5,591,793 | 6,661,657 |
| ACMAT Contracting | <u>1,354,933</u> | <u>2,159,599</u> |
| | <u>\$ 6,946,726</u> | <u>8,821,256</u> |
| Operating Earnings (Loss): | | |
| ACSTAR Bonding | \$ 3,207,416 | 3,726,965 |
| ACMAT Contracting | <u>(1,401,650)</u> | <u>(1,863,361)</u> |
| | <u>\$ 1,805,766</u> | <u>1,863,604</u> |
| Depreciation and Amortization: | | |
| ACSTAR Bonding | \$ 617,578 | 847,453 |
| ACMAT Contracting | <u>(22,360)</u> | <u>477,884</u> |
| | <u>\$ 595,218</u> | <u>1,325,337</u> |
| Identifiable Assets: | | |
| ACSTAR Bonding | \$ 80,737,343 | 84,918,179 |
| ACMAT Contracting | <u>16,943,904</u> | <u>16,945,318</u> |
| | <u>\$ 97,681,247</u> | <u>101,863,497</u> |
| Capital Expenditures: | | |
| ACSTAR Bonding | \$ 59,716 | 7,405 |
| ACMAT Contracting | <u>705,231</u> | <u>642,814</u> |
| | <u>\$ 764,947</u> | <u>650,219</u> |

The components of revenue for each segment are as follows:

| | 2011 | 2010 |
|--|---------------------|------------------|
| ACSTAR Bonding: | | |
| Premiums | \$ 2,626,593 | 3,222,050 |
| Investment income, net | 2,135,568 | 2,449,207 |
| Capital gains | 777,874 | 983,260 |
| Other income | <u>51,758</u> | <u>7,140</u> |
| | <u>\$ 5,591,793</u> | <u>6,661,657</u> |
| ACMAT Contracting: | | |
| Contract revenues | \$ --- | 20,787 |
| Investment income, net | 193,131 | 133,276 |
| Capital gains | 217,197 | 169,155 |
| Intercompany revenue: | | |
| Rental income | 190,266 | 316,598 |
| Underwriting services and agency commissions | 607,224 | 816,238 |
| Other income | <u>147,115</u> | <u>703,545</u> |
| | <u>\$ 1,354,933</u> | <u>2,159,599</u> |

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

| | 2011 | 2010 |
|--|---------------------|------------------|
| Revenue: | | |
| Total revenue for reportable segments | \$ 6,946,726 | 8,821,256 |
| Intercompany eliminations | <u>(499,182)</u> | <u>(758,171)</u> |
| | <u>\$ 6,447,544</u> | <u>8,063,085</u> |
| Operating Earnings: | | |
| Total operating earnings for reportable segments | \$ 1,805,766 | 1,863,604 |
| Impairment loss on building | --- | (401,624) |
| Interest expense | <u>(263,209)</u> | <u>(304,253)</u> |
| | <u>\$ 1,542,557</u> | <u>1,157,727</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 segment 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 intercompany 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.

(17) Subsequent Event

In April 2012, the Company entered into an arrangement with a financial institution to provide financing for the construction and furnishing of a new office building to be opened later in that year. The terms of the financing will increase the current term loan \$1.5 million while extending the maturity date into 2017, reduce the current revolving line of credit by \$2.5 million, and provide a second line of credit of \$1.5 million which will convert into a mortgage upon receipt of a certificate of occupancy.

There were no other subsequent events requiring adjustment to the consolidated financial statements or disclosure through April 20, 2012, the date the Company's consolidated financial statements were issued.

INDEPENDENT AUDITORS' REPORT

The Board of Directors

ACMAT Corporation:

We have audited the accompanying consolidated balance sheets of ACMAT Corporation and its subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of earnings, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ACMAT Corporation and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Hartford, Connecticut

April 20, 2012

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.

| | <u>2011</u> | | <u>2010</u> | |
|--------------------------|-------------|------------|-------------|------------|
| | <u>High</u> | <u>Low</u> | <u>High</u> | <u>Low</u> |
| Common Stock | | | | |
| 1st Quarter | 25.00 | 25.00 | 25.00 | 24.25 |
| 2nd Quarter | 25.26 | 25.00 | 24.70 | 24.35 |
| 3rd Quarter | 25.26 | 24.50 | 24.75 | 24.55 |
| 4th Quarter | 24.50 | 24.50 | 25.00 | 24.60 |
| Class A Stock | | | | |
| 1st Quarter | 26.00 | 24.75 | 24.60 | 22.71 |
| 2nd Quarter | 25.60 | 24.77 | 28.00 | 22.00 |
| 3rd Quarter | 25.75 | 24.95 | 27.75 | 22.50 |
| 4th Quarter | 25.00 | 24.10 | 26.00 | 23.00 |

Annual Meeting

The annual meeting of stockholders will be held on June 28, 2012 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 13, 2012 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

ACMAT CORPORATION AND SUBSIDIARIES

DIRECTORS

Henry W. Nozko, Jr.

Chairman, President &
Chief Executive Officer

Henry W. Nozko III

Executive Vice President & Secretary

John C. Creasy

Former Chief Executive Officer
Danbury Hospital

Arthur R. Moore

Former General President
Sheet Metal Workers'
International Association

Andrew M. Sullivan, Jr.

Retired Partner of KPMG LLP

OFFICERS

Henry W. Nozko, Jr.

Chairman, President &
Chief Executive Officer

Henry W. Nozko III

Executive Vice President & Secretary

Gary M. Case, Esq.

Vice President & General Counsel

Brian P. Marshall, CPA

Vice President – Finance

Maurice C. Shea

Controller

ACSTAR Insurance Company

Henry W. Nozko, Jr.

Chairman, President &
Chief Executive Officer

Henry W. Nozko III

Executive Vice President & Secretary

Gary M. Case, Esq.

Vice President & General Counsel

Brian P. Marshall, CPA

Vice President – Finance

Joan C. Fortier, CPA

Assistant Vice President

Carmen Carlton

Assistant Vice President – Underwriting



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AMINS, Inc.