



ANNUAL REPORT 2010



CORPORATE PROFILE

Originally founded in 1873, AFA has provided over 137 years of uninterrupted Central Station Alarm Service to its customers.

AFA's Central Station service consists of a detecting system installed in subscribers' premises and frequently owned, serviced, monitored and maintained by AFA. The vast majority of signals from subscribers' premises are transmitted to AFA's Central Stations via subscribers' telephone lines, long-range radio or over the Internet. AFA presently operates UL Listed and FM Approved state-of-the-art computerized Central Stations servicing the Eastern United States. These Stations are staffed twenty-four hours a day and monitor approximately 30,000 AFA subscriber locations. The Company also monitors approximately 12,000 locations for customers of approximately 150 Alarm Dealers who do not have their own central stations. Upon receipt of an alarm signal, AFA personnel take the necessary action, which may include alerting Fire or Police Departments, notifying its subscribers and dispatching AFA personnel or other response agents to the protected premises.

THE PRIMARY SCOPE OF AFA'S SERVICES INCLUDES:

- Burglar and vandalism protection;
- Monitoring of subscriber-owned systems;
- Sump pump and air conditioning supervision;
- Flood detection;
- Sprinkler alarm supervision;
- Access control systems;
- Investigator response;
- Fire detection systems;
- Industrial process supervision, including temperature;
- Closed circuit TV (CCTV) systems;
- Boiler supervision;
- Smoke detection;
- Maintenance and testing of high-rise life safety systems.

The majority of the Company's revenues comes from the sale and installation of specialized alarm systems including sophisticated high-rise fire and life safety systems which the Company designs and installs to meet proliferating fire and life safety codes.

AFA does not manufacture detecting equipment. Technology continues to change rapidly and new equipment is so readily available that AFA can better meet subscribers' needs by selecting the finest quality products available from the industry's top suppliers.

AFA's core revenues include the recurring annual service fees paid by customers for Central Station and inspection and maintenance services.

AFA's National Accounts Division continues to add dynamic growth to the Company. The division concentrates on providing fire and security protection to various retail chain stores throughout the United States.

AFA Protective Systems, Inc. and Subsidiaries
LETTER TO OUR SHAREHOLDERS

The Company's results in 2010 can be summed up in one word; disappointing. In essence, despite the historically demonstrated recession-resistant nature of the Company and our interventions during the year, the protracted nature of the recent economic downturn was just too much to overcome. In the end, our financial performance for the year fell short of expectations.

Net income in 2010 amounted to \$997,000 or \$6.51 per share as compared to \$2,155,000 or \$14.05 per share in 2009. Cash flow from operating activities in 2010 amounted to \$829,000 or \$5.41 as compared to \$6,913,000 or \$45.07 per share in 2009. Overall revenues fell for the second consecutive year dropping to \$72,433,000 as compared to \$78,073,000 in 2009. This drop was consistent with results reported by the industry as a whole. As with the prior year, the reduction in revenues was attributable to yet another year of lower booked sales, our third yearly decline in a row. Somewhat mitigating this negative trend was our improved performance in the area of attrition which returned to our normal levels. This improvement was an important factor in our ability to generate an internal gain in our recurring revenue base for the twelfth consecutive year. Also reassuring was that our year-to-year backlog level remained virtually unchanged at year end.

New booked sales in 2010 amounted to \$34,430,000 or about 6% less than 2009, and 35% less than our record results in 2007. The lower top line of Company revenues caused by the cumulative effect of three consecutive years of lower sales, coupled with increased costs in other areas, such as healthcare and direct operating expenses, challenged us throughout the year. The cost-cutting measures we had taken in 2009 were insufficient to totally offset the cumulative negative impact of these developments.

In response, we instituted a number of additional measures to mitigate the negative pressure on our financial statements. For example, for the first time in decades, we resorted to layoffs in branches that did not have ample enough work. We also restructured certain branches resulting in some workforce reductions. In addition, we eliminated some longstanding employee benefit programs that were just too costly to continue with in today's environment. On an emotional level these were difficult decisions, but nevertheless necessary to insure the immediate and long-term health of the Company.

The branch most adversely affected by the economy in 2010 was our National Accounts Division. In fact, virtually all of the year to year reduction in new sales for 2010 can be traced to this Division. In retrospect, we believe the "off year" for National Accounts was an anomaly. It appears that the lower sales were due largely to the fact that many chain accounts decided to delay implementation of orders originally scheduled to be placed in 2010 because of the economy. In support of this belief, we have already seen a spike in new business from National Accounts during the first quarter of 2011. This lends credence to our hope that our National Accounts customer base will make up for 2010 by actually placing those delayed orders as well as those already scheduled for 2011. That, coupled with the fact that this Division has already brought in three new chain accounts in the first quarter, has the makings of 2011 being a huge bounce back year.

Unquestionably, the star performer in 2010 was our flagship New York Branch. Bucking the trend of the rest of the Company, our largest Branch enjoyed increases in sales, profit, backlog and recurring revenue. These results were aided by the Branch's exceptionally low attrition rate of 5.2%. The Branch's performance was good by any standard, but given the environment in 2010, it was spectacular, salvaging the year for the Company.

The New England Branch also performed well overall given the environment, with most results consistent with those of the prior year. The Company was able to successfully negotiate a new three-year agreement with the local union representing our field technicians in Boston which should promote harmony and stability in the Branch for the foreseeable future.

Our New Jersey Branch felt the effects of the economy more keenly. This hard hit region experienced a 15% reduction in new sales, and a higher than normal attrition rate. Although the Branch was able to maintain its level of profitability, this translated into lower recurring revenue and backlog totals going into 2011.

Sales and profitability dipped noticeably in the Georgia Branch in 2010. However, we were excited to make a significant acquisition during the third quarter which infused approximately \$600,000 in annual recurring revenue to the Branch, most of which is associated with prestigious subscribers. In addition to increasing the Branch's recurring

revenue base by 40%, these new subscribers started to generate additional business for us by year end. We are confident that this acquisition will enable this Branch to post improved results in 2011 and beyond.

The Midlantic Branch suffered, primarily due to the fall off in National Accounts sales, but also due to administrative issues. We have changed the management team in the Branch to correct these issues as well as to generate better sales internally.

Our most serious issues during the year emanated from the North Carolina and Florida Branches. By midyear, the North Carolina operation model had become intolerable. After racking up significant losses in the first half, management acted to totally revamp the branch in both size and focus. The lack of enough work prompted a major downsizing of employees. In addition, we totally eliminated from our repertoire the sales of new business that was unprofitable. Local management was changed as well. The end result was that we were able to limit the Branch's drain on the Company and position it to be a viable contributor going forward. Early results in 2011 support that conclusion.

The biggest problem we faced during the year was the Florida Branch. Having to endure a service drop off in National Accounts sales, two local management changes and a costly to service geographic area, the Branch's performance continued to decline. How to go forward with this Branch is our top concern and priority today. Management is currently assessing various scenarios for our Florida Branch and we expect to have a definitive direction for it by midyear.

Last year at this time I listed five initiatives we had undertaken to improve the Company. While still a work in progress, here is where those stand:

- 1) Upgrading our accounting system—We are close to completion of this project, which should be implemented momentarily. Once in place and operational, we believe this will make us more efficient and productive both administratively and operationally.
- 2) Review and revise employee benefits—Completed. We have brought our benefits program more in line with the real world today, while still maintaining them at better than industry norm levels. We anticipate realization of annual savings going forward of between \$500,000 and \$1,000,000 per year.

- 3) Becoming lean—This is an ongoing process. However, as previously mentioned herein, during 2010 we did have layoffs and restructuring in some branches that ended up reducing our total workforce by approximately five percent. Our goal is to fulfill our work obligations at the highest industry levels through the maximization of our employees' productivity, not by simply "adding bodies."
- 4) Expand our service capability—We are now willing to service equipment from different manufacturers, as well as offer different types of services.
- 5) Reevaluate our pricing—Absent special circumstances, we will not undertake any project that is not profitable in its own right.

Despite the challenges we have had to face over the past two years and the ones we face today, our underlying confidence in the Company's future is unshaken. It was as a result of our confidence, as well as the uncertainty of future tax laws and favorable interest rates at the time, that your Board of Directors decided to declare a special dividend in the fourth quarter of 2010 as in the best interests of all our shareholders. Although some leveraging was necessary to finance the dividend, we believe the resulting debt will be repaid within a reasonable period out of normal operating income and will not negatively affect any of our ongoing initiatives or opportunities.

As for the immediate future, we are guardedly optimistic. We believe the corner has been turned and that we should see more positive results by the second half of 2011. As always, we thank you all for all of your confidence and support over the years.



Robert D. Kleinman
Chairman and Chief Executive Officer

AFA Protective Systems, Inc. and Subsidiaries
CONSOLIDATED BALANCE SHEETS

| December 31, | 2010 | 2009 |
|--|--------------|--------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 2,386,753 | \$ 5,492,771 |
| Accounts receivable, net of allowance for doubtful accounts | 12,256,549 | 11,260,971 |
| Inventory, other than installation materials | 4,575,403 | 4,835,857 |
| Prepaid expenses and other current assets | 868,782 | 733,573 |
| Total current assets | 20,087,487 | 22,323,172 |
| Property, plant and equipment, net | 8,672,565 | 9,557,013 |
| Inventory of installation materials | 127,931 | 168,151 |
| Goodwill and intangible assets, net | 481,068 | 479,574 |
| Other assets | 176,462 | 150,216 |
| Total assets | \$29,545,513 | \$32,678,126 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities | | |
| Current portion of long-term debt | \$ 1,357,752 | \$ 242,657 |
| Accounts payable | 2,873,791 | 3,259,394 |
| Accrued expenses and other current liabilities | 5,305,166 | 6,019,700 |
| Deferred revenues | 6,816,579 | 7,141,651 |
| Total current liabilities | 16,353,288 | 16,663,402 |
| Long-term debt | 7,295,232 | 3,244,651 |
| Deferred income taxes | — | 154,600 |
| Pension obligation | 1,550,565 | 891,707 |
| Obligation for postretirement benefits | 293,044 | 302,426 |
| Deferred revenues | 2,221,107 | 2,409,388 |
| Fair value of interest rate swaps | 328,665 | 249,606 |
| Total liabilities | 28,041,901 | 23,915,780 |
| COMMITMENTS AND CONTINGENCIES (NOTE 16) | | |
| Shareholders' equity | | |
| Common stock, \$1 par value; 153,278 shares authorized, issued and outstanding in 2010 and 2009 | 153,278 | 153,278 |
| Additional paid-in capital | 316,142 | 316,142 |
| Accumulated other comprehensive loss | (1,653,909) | (1,368,280) |
| Retained earnings | 2,688,101 | 9,661,206 |
| Total shareholders' equity | 1,503,612 | 8,762,346 |
| Total liabilities & shareholders' equity | \$29,545,513 | \$32,678,126 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

| Years Ended December 31, | 2010 | 2009 |
|--|--------------|--------------|
| Revenues | | |
| Sales | \$42,443,870 | \$48,023,623 |
| Service | 29,989,431 | 30,049,342 |
| | 72,433,301 | 78,072,965 |
| Costs and expenses | | |
| Cost of sales | 31,237,807 | 34,673,822 |
| Cost of services, exclusive of depreciation and amortization | 19,189,425 | 19,030,836 |
| Depreciation and amortization | 2,028,294 | 2,132,947 |
| Selling, general, and administrative | 17,988,592 | 18,412,625 |
| | 70,444,118 | 74,250,230 |
| Income from operations | 1,989,183 | 3,822,735 |
| Interest and dividend income | 80,428 | 101,342 |
| Interest expense, net | (309,261) | (134,058) |
| Income before provision for income taxes | 1,760,350 | 3,790,019 |
| Provision for income taxes | 763,000 | 1,635,000 |
| Net income | \$ 997,350 | \$ 2,155,019 |
| Earnings per share | \$ 6.51 | \$ 14.05 |
| Weighted average number of shares outstanding | 153,278 | 153,388 |
| Dividends per share | \$ 52.00 | \$ 2.00 |
| Comprehensive income | | |
| Net income | \$ 997,350 | \$ 2,155,019 |
| Other comprehensive loss, net of tax | | |
| Net actuarial loss arising during the year | (285,629) | (566,136) |
| Comprehensive income | \$ 711,721 | \$ 1,588,883 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

Years Ended December 31, 2010 and 2009

| | Number of Shares | Common Stock | Additional Paid-in Capital | Accumulated Other Comprehensive Loss | Retained Earnings | Total |
|---|---------------------|-----------------|-------------------------------|---|----------------------|--------------|
| Balance at December 31, 2008 | 153,420 | \$153,420 | \$316,416 | \$ (802,144) | \$ 7,848,044 | \$ 7,515,736 |
| Net income for the year | — | — | — | — | 2,155,019 | 2,155,019 |
| Cash dividends (\$2.00 per share) | — | — | — | — | (306,773) | (306,773) |
| Net actuarial loss arising during the year, net of taxes | — | — | — | (566,136) | — | (566,136) |
| Purchase and retirement of common stock | (142) | (142) | (274) | — | (35,084) | (35,500) |
| Balance at December 31, 2009 | 153,278 | \$153,278 | \$316,142 | \$(1,368,280) | \$ 9,661,206 | \$ 8,762,346 |
| Net income for the year | — | — | — | — | 997,350 | 997,350 |
| Cash dividends (\$52.00 per share) | — | — | — | — | (7,970,455) | (7,970,455) |
| Net actuarial loss arising during the year, net of taxes | — | — | — | (285,629) | — | (285,629) |
| Balance at December 31, 2010 | 153,278 | \$153,278 | \$316,142 | \$(1,653,909) | \$ 2,688,101 | \$ 1,503,612 |

The accompanying notes are an integral part of these consolidated financial statements.

AFA Protective Systems, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS

| Years Ended December 31, | 2010 | 2009 |
|--|--------------|--------------|
| Cash flows from operating activities | | |
| Net income | \$ 997,350 | \$ 2,155,019 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization | 2,065,763 | 2,153,065 |
| Deferred income taxes | 53,600 | 241,400 |
| Loss/(gain) on interest rate swap | 79,059 | (222,602) |
| Changes in operating assets and liabilities | | |
| Accounts receivable | (995,578) | 2,641,776 |
| Inventory, other than installation materials | 260,454 | 413,724 |
| Prepaid expenses and other current assets | (135,209) | (145,269) |
| Other assets | (38,631) | (13,323) |
| Accounts payable | (385,603) | (294,326) |
| Accrued expenses and other current liabilities | (732,334) | (93,104) |
| Deferred revenues | (513,353) | 170,233 |
| Liability for postretirement benefits | 173,447 | (93,324) |
| Net cash provided by operating activities | 828,965 | 6,913,269 |
| Cash flows from investing activities | | |
| Capital expenditures | (1,102,716) | (1,450,507) |
| Acquisition of intangible assets | (27,488) | — |
| Net cash used in investing activities | (1,130,204) | (1,450,507) |
| Cash flows from financing activities | | |
| Dividends paid | (7,970,455) | (306,773) |
| Purchase and retirement of common stock | — | (35,500) |
| Proceeds from borrowings—Term loan | 5,500,000 | — |
| Repayments of mortgage note | (242,657) | (228,447) |
| Repayments of term loan | (91,667) | (2,099,986) |
| Net cash used in financing activities | (2,804,779) | (2,670,706) |
| Net (decrease)/increase in cash and cash equivalents | (3,106,018) | 2,792,056 |
| Cash and cash equivalents | | |
| Beginning | 5,492,771 | 2,700,715 |
| Ending | \$ 2,386,753 | \$ 5,492,771 |
| Supplemental disclosures of cash flow information | | |
| Cash paid for: | | |
| Interest | \$ 210,876 | \$ 336,543 |
| Income taxes | 951,868 | 1,613,555 |

The accompanying notes are an integral part of these consolidated financial statements.

AFA Protective Systems, Inc. and Subsidiaries
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND BASIS OF PRESENTATION

Description of the Business

AFA Protective Systems, Inc. and Subsidiaries (the “Company”) is engaged in the installation, operation, maintenance and sale of protective systems to safeguard life and property from a variety of hazards. Operations are conducted primarily in the eastern United States.

Basis of Presentation

The financial statements include the accounts of AFA Protective Systems, Inc. and its subsidiaries, all of which are wholly owned. All intercompany balances and transactions have been eliminated in consolidation.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition

Service charges to alarm system subscribers, for services to be rendered over a maximum period of one year, are deferred and taken into income as earned over the service period. Advance service billings on new subscribers are also deferred and reflected in income over a five-year period, the term of most contracts. For income tax purposes, the Company reports advance billings as income in the year billed. Selling expenses in connection with obtaining new subscribers are charged to income from operations as incurred.

The percentage-of-completion method is used for the recognition of revenue from sales of security systems under long-term contracts in accordance with ASC 605-35, “Revenue Recognition—Construction-Type and Production-Type Contracts,” and is based on the ratio of costs incurred to date on the contract to total estimated contract costs, after providing currently for all known or anticipated losses. Due to uncertainties inherent in the estimation process, it is possible that completion costs will be revised in the near term. Such revisions to costs and income are recognized in the period in which the revisions are determined.

Fair Value of Financial Instruments

In assessing the fair value of financial instruments at December 31, 2010 and 2009, the Company has used a variety of methods and assumptions, which were based on estimates of market conditions and risks existing at the time. The fair value of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximate their carrying value because of the current nature of these instruments. The carrying value of the Company’s long-term borrowings at December 31, 2010 and 2009 approximate fair value as interest rates approximate current market rates based on their variable nature. The Company believes its mortgage

interest rate reflects current market rates. The Company’s interest rate swaps have been measured at fair value under the principles.

Cash and Cash Equivalents

Cash and cash equivalents include short-term investments with original maturities of 90 days or less. At December 31, 2010 and 2009, cash and cash equivalents included money market funds of \$1,046,800 and \$1,040,010, respectively. Cash and cash equivalents held at financial institutions may at times exceed federally insured amounts. The Company believes it mitigates its risks by investing in or through major financial institutions.

Accounts Receivable

Accounts receivable are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a regular basis. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer’s financial condition, credit history and current economic conditions. Accounts receivable are written off when deemed uncollectible. Recoveries of accounts receivable previously written off are recorded when received.

Inventories

Inventory, other than installation materials, consists of finished goods, work in progress and parts related to the sale of security systems which are carried at the lower of cost (on a first-in, first-out basis) or market. Inventory of installation materials is classified as noncurrent assets in the consolidated balance sheets. The Company classifies only inventory to be used to construct Company-owned systems at subscriber premises as inventory of installation materials. The Company continues to evaluate the inventories on a periodic basis for slow moving, excess and obsolete stock on hand.

Property, Plant and Equipment

Property, plant and equipment are recorded at their historical cost and depreciated over their estimated useful lives, which range from 3 to 30 years. Maintenance and repairs are charged to expense as incurred; renewals and improvements that extend the life of the asset are capitalized. Upon retirement or sale, the asset cost and related accumulated depreciation are eliminated from the respective accounts and the resulting gains or loss, if any, is included in the results of operations for the year. Leasehold improvements are amortized over the shorter of the lease term or remaining useful life of the related assets.

Central station equipment, equipment in subscribers' premises and other equipment are depreciated primarily by accelerated methods. The straight-line method is used for buildings and leasehold improvements. For income tax purposes, installation costs are deducted as incurred and accelerated methods and rates are used for all other assets.

Debt Issue Costs

Debt issue costs are being amortized using the interest method over the term of the related debt. Amortization of \$12,384 and \$20,117 has been recorded in interest expense in the consolidated statements of income and comprehensive income in each of the years ended December 31, 2010 and 2009, respectively.

Goodwill and Intangible Assets

Goodwill and indefinite lived intangible assets are not amortized but instead are reviewed annually for impairment or more frequently if impairment indicators arise. The Company tests for impairment whenever events or changes in circumstances indicate that the carrying amount of goodwill or other intangible assets may not be recoverable or at least annually at December 31 of each year. In the event that the Company determines that the value of goodwill or other intangible assets have become impaired, the Company will incur a charge for the amount of the impairment during the fiscal period in which the determination is made. The Company completed its review and determined there was no impairment during the years ended December 31, 2010 and 2009 (Note 5). Identifiable intangible assets primarily represent alarm contracts arising from acquisitions and are amortized on a straight-line basis over their estimated useful lives ranging primarily from four to eight years.

Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate the carrying value of the assets may not be recoverable. In reviewing for impairment, the Company compares the carrying value of the assets to the estimated undiscounted future cash flows expected from the use of the assets and their eventual disposition. When the estimated undiscounted future cash flows are less than their carrying amount, an impairment loss is recognized equal to the difference between the assets' fair value and its carrying amount. The Company believes the future cash flows to be received from its long-lived assets exceed the assets' carrying value, and accordingly, the Company has not recognized any impairment losses for the years ended December 31, 2010 and 2009.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, are primarily trade accounts receivable. Customers in the commercial real estate industry, principally commercial building properties, account for a substantial portion of trade receivables. Credit risk with respect to trade receivables is generally minimized due to the large corporations and other organizations the Company services. Accounts receivable due from a major customer amounted to approximately \$2,597,000 and \$1,556,000 at December 31, 2010 and 2009, respectively. Billings to this customer amounted to \$17,907,000 and \$21,091,000 for the years ended December 31, 2010 and 2009, respectively.

Advertising Costs

Costs for advertising are expensed when incurred. Advertising expense was approximately \$162,000 and \$205,000 for the years ended December 31, 2010 and 2009, respectively.

Earnings per Share

Earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the reporting period. The Company has no dilutive securities.

Income Taxes

Deferred income taxes are provided for the tax effects of differences between the financial reporting and tax bases of the Company's assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and establishes a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include accounting for long-term contracts, the allowance for doubtful accounts, inventory obsolescence, depreciation and amortization, employee benefit plans, income taxes and contingencies.

Derivative Financial Instruments

The Company accounts for derivative instruments in accordance with ASC 815, "Derivatives and Hedging." ASC 815 requires that the Company recognize all derivatives as assets or liabilities and measure those instruments at fair value. The Company uses derivatives for the purpose of hedging exposure to changes of interest rates. For the year ended December 31, 2010, the Company recognized a loss of \$79,059 and for the year ended December 31, 2009 the Company recognized a gain of \$222,602 on its interest rate swaps, respectively. As such, hedges do not qualify for hedge accounting. Both changes resulted from changes in the fair value of the derivatives, which has been included as a component of interest expense in the consolidated statements of income and comprehensive income. The Company does have one hedge that qualifies for hedge accounting, though fair value of such hedge at December 31, 2010 is insignificant.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income or loss. Other comprehensive income or loss consists of the net unrealized actuarial gains or losses related to the Company's postretirement and pension plans, net of income taxes.

Subsequent Events

The Company evaluated all events and transactions that occurred after the balance sheet date of December 31, 2010 through March 31, 2011 the date it issued these financial statements. Any subsequent events that required recognition or disclosure have been reflected in these financial statements.

Recently Issued Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued the FASB Accounting Standards Codification (the "Codification"). The Codification is the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. The Codification eliminates the GAAP hierarchy contained in Statement of Financial Accounting Standards and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. In response, the Company has used plain English or included the references to the Codification, as appropriate, in these consolidated financial statements.

On January 1, 2008, the FASB issued new accounting guidance on fair value measurement. The guidance does not require any new fair value measurements but provides a definition of fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. On January 1, 2009, the Company adopted the guidance as it relates to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on at least an annual basis. The guidance defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America ("GAAP"), and expands disclosures about fair value measurements. The provisions of this standard apply to other accounting pronouncements that require or permit fair value measurements and are to be applied prospectively with limited exceptions. The adoption of the guidance did not have a material impact on the Company's consolidated financial statements.

In May 2009, the FASB issued guidance which establishes general standards of: 1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; 2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and 3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The adoption of this guidance did not impact the Company's consolidated financial statements.

In June 2009, the FASB issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities. The amended guidance eliminates exceptions to consolidating qualifying special-purpose entities, contains new criteria for determining the primary beneficiary, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. This guidance also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a variable interest entity, a company's power over a variable interest entity, or a company's obligation to absorb losses or its right to receive benefits of an entity must be disregarded. The elimination of the qualifying special-purpose entity concept and its consolidation exception means more entities will be subject to consolidation assessments and reassessments. The Company has adopted these statements for interim and annual reporting periods beginning on January 1, 2010.

3. ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

| December 31, | 2010 | 2009 |
|--|--------------|--------------|
| Trade receivables, including progress bills and amounts due on completed contracts | \$10,979,868 | \$10,299,890 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 1,426,681 | 1,111,081 |
| | 12,406,549 | 11,410,971 |
| Less: allowance for doubtful accounts | (150,000) | (150,000) |
| | \$12,256,549 | \$11,260,971 |

Cost and estimated earnings on uncompleted contracts and related amounts billed were as follows:

| December 31, | 2010 | 2009 |
|--|--------------|--------------|
| Costs incurred on uncompleted contracts | \$ 4,063,284 | \$ 2,678,159 |
| Estimated earnings | 1,541,845 | 904,714 |
| | 5,605,129 | 3,582,873 |
| Less: billings to date | (4,394,502) | (2,847,996) |
| | 1,210,627 | 734,877 |
| Costs and estimated earnings in excess of billings (included in accounts receivable) | (1,426,681) | (1,111,081) |
| Billings in excess of costs (included in accrued expenses and other current liabilities) | \$ (216,054) | \$ (376,204) |

Costs and estimated earnings in excess of billings on uncompleted contracts arise in the consolidated balance sheets when revenues have been recognized but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers based upon various measures of performance, including achievement of certain milestones or completion of the contract. Substantially all amounts recorded as costs and estimated earnings in excess of billings on uncompleted contracts at December 31, 2010, are expected to be billed and collected within one year.

4. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment, net consists of the following:

| | Estimated Lives | December 31, 2010 | 2009 |
|-------------------------------------|-------------------------------------|-------------------|--------------|
| Land | | \$ 242,000 | \$ 242,000 |
| Buildings | 30 | 4,679,235 | 4,679,235 |
| Equipment in subscribers' premises | 10-25 | 46,346,602 | 45,511,961 |
| Central station and other equipment | 3-10 | 16,134,969 | 15,759,567 |
| Leasehold improvements | Lesser of lease term or useful life | 380,121 | 380,120 |
| Installations in progress | * | 222,170 | 289,278 |
| | | 68,005,097 | 66,862,161 |
| Less: accumulated depreciation | | (59,332,532) | (57,305,148) |
| | | \$ 8,672,565 | \$ 9,557,013 |

*Depreciation expense is initiated once equipment is fully installed and operational.

Depreciation expense was \$2,027,385 and \$ 2,098,244 for the years ended December 31, 2010 and 2009, respectively.

5. GOODWILL AND INTANGIBLE ASSETS, NET

Goodwill and intangible assets, net consists of the following:

| | Estimated Lives | December 31, 2010 | 2009 |
|-------------------------------------|-----------------|-------------------|------------|
| Goodwill | — | \$ 441,301 | \$ 441,301 |
| Alarm contracts | 4-8 years | 277,500 | 250,012 |
| Gross goodwill and intangibles | | 718,801 | 691,313 |
| Less: accumulated amortization | | (237,733) | (211,739) |
| Goodwill and intangible assets, net | | \$ 481,068 | \$ 479,574 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amortization of intangible assets was \$25,994 and \$34,703 during the years ended December 31, 2010 and 2009, respectively. Future estimated amortization expense for the next five years is as follows as of December 31, 2010:

| Years Ending December 31, | |
|---------------------------|-----------------|
| 2011 | \$16,778 |
| 2012 | 8,521 |
| 2013 | 5,867 |
| 2014 | 5,627 |
| 2015 | 3,204 |
| | <u>\$39,997</u> |

6. OTHER ASSETS

Other assets consist of the following:

| December 31, | 2010 | 2009 |
|--------------------------------|------------------|------------------|
| Debt issue costs, net (Note 2) | \$ 83,834 | \$ 64,187 |
| Other | 92,628 | 86,029 |
| | <u>\$176,462</u> | <u>\$150,216</u> |

7. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following:

| December 31, | 2010 | 2009 |
|--|--------------------|--------------------|
| Salaries, wages and vacation | \$3,077,464 | \$2,757,982 |
| Employee benefit plan contribution | 446,050 | 1,188,264 |
| Current portion of liability for postretirement benefits | 47,300 | 55,385 |
| Income taxes payable | 211 | 38,135 |
| Billings in excess of costs | 216,055 | 376,204 |
| Healthcare costs payable | 500,000 | 350,000 |
| Refundable NYC Fire Department fees | 831,635 | 1,072,508 |
| Other | 186,451 | 181,222 |
| | <u>\$5,305,166</u> | <u>\$6,019,700</u> |

8. LONG-TERM DEBT

Long-term debt consists of the following:

| December 31, | 2010 | 2009 |
|-----------------------|---------------------|--------------------|
| Term loan | \$ 5,408,333 | \$ — |
| Mortgage note | 3,244,651 | 3,487,308 |
| | 8,652,984 | 3,487,308 |
| Less: current portion | (1,357,752) | (242,657) |
| Long-term debt | <u>\$ 7,295,232</u> | <u>\$3,244,651</u> |

Future maturities of long-term debt are as follows:

| Years ending December 31, | |
|---------------------------|--------------------|
| 2011 | \$1,357,752 |
| 2012 | 1,373,790 |
| 2013 | 1,390,820 |
| 2014 | 1,408,910 |
| 2015 | 3,121,712 |
| | <u>\$8,652,984</u> |

On June 1, 2005, the Company obtained a \$7,000,000 five-year term loan from its primary bank collateralized by a blanket U.C.C. filing against its assets. Repayment was to be made in monthly principal installments of \$116,667 with an interest rate of LIBOR plus 1.6%. The terms of the agreement contained various restrictive covenants which included, but were not limited to, maintenance of certain income to debt service ratios and certain adjusted earnings requirements, as defined. On December 10, 2009, the Company prepaid \$700,089 representing the balance due on its term loan plus accrued interest.

On June 1, 2005, the Company obtained a \$4,400,000 ten-year mortgage from its primary bank collateralized by three buildings owned by the Company whose carrying value at December 31, 2010 and 2009 was approximately \$1,564,000 and \$1,720,000, respectively. Repayment is to be made in equal monthly installments of \$37,249 based on an amortization schedule of fifteen years with interest of LIBOR plus 1.52%. The remaining principal balance of \$1,924,393 will be due in full on July 15, 2015.

On December 1, 2010, the Company obtained a \$5,500,000 five-year term loan from its primary bank collateralized by a blanket U.C.C. filing against its assets. Repayment is to be made in monthly principal installments of \$91,667 with an interest rate of LIBOR plus 1.75%. The terms of the agreement contain various restrictive covenants which include, but are not limited to, maintenance of certain income to debt service ratios and certain adjusted earnings requirements, as defined.

In connection with the mortgage loan, the Company entered into an interest rate swap agreement, (the “Swap”), with its primary bank to effectively fix its variable interest rate at 6.05%. The fair value of the Swap of \$(328,665) and \$(249,606) at December 31, 2010 and 2009, respectively, has been recorded based on current market rates. The Company has a swap on its five-year term loan with its lender to effectively fix its interest rate on the related debt at 3.44%. Such swap had a normal value at December 31, 2010 and will be treated as a hedge.

The Company has available \$3,600,000 in a line of credit with its primary bank collateralized by a blanket U.C.C. filing against its assets expiring June 3, 2011. Interest is payable at LIBOR plus 2.10%. Use of the funds are unrestricted. At December 31, 2010 and 2009, the Company had \$3,600,000 of its line of credit available for use.

9. DEFERRED REVENUES

Deferred revenues consist of annual service and other charges and advance service charges. Annual service and other charges represent customer billings for services not yet rendered for which the maximum billing period is one year and have been reflected as a current liability. Advance service charges consist of nonrefundable charges billed to customers at the time of new installations. The portion of these charges expected to be recognized within one year has been classified as current on the balance sheet at December 31, 2010 and 2009. An analysis of deferred revenues is as follows:

| | Annual Service and Other Charges | Advance Service Charges | Total |
|----------------------------|--|-------------------------------|--------------|
| Balance, December 31, 2008 | \$ 5,490,252 | \$ 3,890,554 | \$ 9,380,806 |
| Billings | 28,785,616 | 1,433,959 | 30,219,575 |
| Amortizations to income | (28,522,217) | (1,527,125) | (30,049,342) |
| Balance, December 31, 2009 | 5,753,651 | 3,797,388 | 9,551,039 |
| Billings | 28,244,657 | 1,231,421 | 29,476,078 |
| Amortizations to income | (28,489,729) | (1,499,702) | (29,989,431) |
| Balance, December 31, 2010 | \$ 5,508,579 | \$ 3,529,107 | \$ 9,037,686 |

10. COMMON STOCK

Issuance of Employee Stock Appreciation Rights

The Company issued stock appreciation rights to certain employees in January 2007 which will be payable only upon sale of the Company or change in its control, as defined. Since the sale of the Company or change in its control, as defined, are contingent events, no compensation expense is recorded until such events are probable of occurrence.

Stock Repurchases

The Company purchased and retired 142 shares of common stock for \$35,500 during the year ended December 31, 2009.

11. INCOME TAXES

Components of the provision for income taxes are as follows:

| December 31, | 2010 | 2009 |
|-----------------|-----------|-------------|
| Current | | |
| Federal | \$605,465 | \$1,013,452 |
| State and local | 103,935 | 380,148 |
| | 709,400 | 1,393,600 |
| Deferred | | |
| Federal | 36,600 | 203,400 |
| State and local | 17,000 | 38,000 |
| | 53,600 | 241,400 |
| | \$763,000 | \$1,635,000 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of the federal statutory rate and the Company's effective tax rate follows:

| | 2010 | 2009 |
|--|-------|-------|
| Federal statutory rate | 34.0% | 34.0% |
| State and local income taxes, net of federal income tax benefit | 6.3% | 7.6% |
| Other items | 3.0% | 1.5% |
| Effective rate | 43.3% | 43.1% |

The effective tax rate differed from the federal statutory tax rate primarily as result of state income taxes and certain non-taxable income.

The tax effects of the significant temporary differences which comprise the deferred tax assets and liabilities at December 31 are as follows:

| December 31, | 2010 | 2009 |
|---|--------------|--------------|
| Deferred Tax Assets | | |
| Advance service revenue | \$ 1,519,100 | \$ 1,620,600 |
| Intangibles | 378,100 | 540,500 |
| Net operating loss carryforwards (state) | 18,000 | — |
| Benefit plans | 765,100 | 513,900 |
| Other | 262,600 | 236,600 |
| | 2,942,900 | 2,911,600 |
| Less: valuation allowance | (18,000) | — |
| Deferred tax assets | 2,924,900 | 2,911,600 |
| Deferred Tax Liabilities | | |
| Depreciation | (2,808,300) | (2,947,600) |
| Other | (110,000) | (118,600) |
| Net deferred tax assets (liabilities) | \$ 6,600 | \$ (154,600) |

As of December 31, 2010 and 2009, the Company recorded a valuation allowance of \$18,000 and \$0, respectively, on the deferred tax assets to reduce the total to an amount that management believes will ultimately be realized. Realization of deferred tax assets is dependent upon sufficient future taxable income during the period that deductible temporary differences and carryforwards are expected to be available to reduce taxable income. The net change in the valuation allowance against deferred tax assets were an increase of \$18,000 and a decrease of \$5,300 during the years ended December 31, 2010 and 2009, respectively.

Liabilities for uncertain tax positions reflected as of December 31, 2010 are not significant and it is not anticipated that they will materially change in the next 12 months. With limited exceptions, the Company is no longer

subjected to tax audits by taxing authorities for years through 2006 for all jurisdictions. Although the outcome of tax audits is always uncertain, the Company believes that its tax positions will generally be sustained under audit.

Interest expense and penalties related to income tax matters are recognized as a component of interest expense. For the years ended December 31, 2010 and 2009, the Company did not record any liabilities or expenses related to tax penalties and related interest.

12. RETIREMENT BENEFITS

The Company maintains a noncontributory defined benefit pension plan for its hourly union employees who meet certain requirements of age, length of service and hours worked per year. The benefits provided are based upon years of service and the employee's compensation during the last five years of employment. The Company's funding policy is to contribute annually at least the minimum amount required by Federal regulations. Effective October 15, 1996, the collective bargaining agreement covering the New York/New Jersey union employees was terminated following a strike, which resulted in a workforce reduction. Accordingly, the plan was amended effective December 31, 1996, to eliminate benefit accruals for the remaining New York/New Jersey employees. Effective January 1, 1997, the plan was further amended to provide those participants whose benefits were frozen due to the termination of the union agreement, to have their benefits determined using the method applicable for early retirement if they continue in service until then. In conjunction with the Company's collective bargaining agreement effective August 1, 2007 covering its Massachusetts union employees effective February 1, 2008, the plan was amended to eliminate benefit accruals for the Massachusetts employees, and new employees are no longer eligible to enter the plan.

The Company provides certain health care and life insurance benefits to retired employees who have attained age 62 or 20 years of service at the date of retirement, whichever is later. Eligible retirees under age 65 are covered by the Company's health insurance plan, at a cost to the retiree equal to the Company's cost for an active employee. After attaining age 65, an eligible retiree's health care benefit coverage becomes coordinated with Medicare, with the retiree paying a portion of the cost of the coverage in excess of certain amounts. Effective December 31, 1996, the Company eliminated future benefits for employees who had not already retired or had given notice of retirement at that date. The Company's funding policy is generally to pay covered expenses as they are incurred.

The following is a reconciliation of the benefit obligation, fair value of plan assets and funded status of the Company's defined benefit and other postretirement benefit plans measured at December 31, 2010 and 2009, respectively:

| | Pension Benefits | | Other Postretirement Benefits | |
|---|----------------------|---------------------|-------------------------------|--------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Change in Benefit Obligation | | | | |
| Benefit obligation at beginning of year | \$ 5,946,438 | \$5,501,696 | \$ 357,811 | \$ 265,275 |
| Service cost | — | — | — | — |
| Interest cost | 351,723 | 336,988 | 16,855 | 20,606 |
| Actuarial loss | 645,551 | 341,602 | 4,960 | 124,179 |
| Benefits paid | (246,287) | (233,848) | (39,281) | (52,249) |
| Benefit obligation at end of year | \$ 6,697,425 | \$5,946,438 | \$ 340,345 | \$ 357,811 |
| Change in Plan Assets | | | | |
| Fair value of plan assets at beginning of year | \$ 5,054,731 | \$5,266,220 | \$ — | \$ — |
| Actual return on plan assets | 338,416 | 171,140 | — | — |
| Employer contribution | — | — | 39,281 | 52,249 |
| Benefits paid | (246,287) | (382,629) | (39,281) | (52,249) |
| Fair value of plan assets at end of year | \$ 5,146,860 | \$5,054,731 | \$ — | \$ — |
| Net amount recognized | \$(1,550,565) | \$ (891,707) | \$(340,345) | \$(357,811) |

Amounts recognized in the consolidated balance sheet consist of:

| | Pension Benefits | | Other Postretirement Benefits | |
|--|----------------------|--------------------|-------------------------------|--------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Accrued pension liability | \$(1,550,565) | \$(891,707) | \$ — | \$ — |
| Current portion of liability for postretirement benefits | — | — | (47,300) | (55,385) |
| Non-current liability for postretirement benefits | — | — | (293,045) | (302,426) |
| Net amount recognized | \$(1,550,565) | \$(891,707) | \$(340,345) | \$(357,811) |

Amounts recognized in accumulated other comprehensive loss consist of:

| | Pension Benefits | | Other Postretirement Benefits | |
|----------------|--------------------|--------------------|-------------------------------|------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Actuarial loss | \$2,505,961 | \$1,993,886 | \$250,748 | \$286,794 |
| | \$2,505,961 | \$1,993,886 | \$250,748 | \$286,794 |

The amounts shown above have been recognized in accumulated other comprehensive loss totaling \$1,653,909, net of deferred income tax assets of \$1,102,800 at December 31, 2010 and accumulated other comprehensive loss totaling \$1,368,280, net of deferred income tax assets of \$912,400 at December 31, 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts recorded in other comprehensive loss consist of:

| | Pension Benefits | | | Other Postretirement Benefits | | |
|--|-------------------|--------------------------|-------------------|-------------------------------|--------------------------|-------------------|
| | 2010 | | | 2010 | | |
| | Before Tax Amount | Tax (Expense) or Benefit | Net of Tax Amount | Before Tax Amount | Tax (Expense) or Benefit | Net of Tax Amount |
| Net actuarial loss arising during the year | \$627,810 | \$250,800 | \$377,010 | \$ 4,960 | \$ 2,000 | \$ 2,960 |
| Less: amortization included in net periodic pension cost | 115,735 | 46,000 | 69,735 | 41,006 | 16,400 | 24,606 |
| Net change during the year | \$512,075 | \$204,800 | \$307,275 | \$(36,046) | \$(14,400) | \$(21,646) |

Components of net periodic pension and other postretirement benefits cost:

| | Pension Benefits | | Other Postretirement Benefits | |
|--------------------------------|------------------|-------------|-------------------------------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Interest cost | \$ 351,723 | \$ 336,988 | \$16,854 | \$20,606 |
| Expected return on plan assets | (320,675) | (418,789) | — | — |
| Amortization of net losses | 115,735 | 59,813 | 41,006 | 30,002 |
| | \$ 146,783 | \$ (21,988) | \$57,860 | \$50,608 |

Amounts recorded in accumulated other comprehensive loss expected to be recognized as a component of net periodic pension cost in 2011 are as follows:

| | Pension Benefits | Other Postretirement Benefits |
|----------------|------------------|-------------------------------|
| Actuarial loss | \$127,897 | \$34,520 |
| Total | \$127,897 | \$34,520 |

Weighted average assumptions used to determine the benefit obligation and net periodic pension and other postretirement benefits cost as of and for the years ended December 31:

| | Pension Benefits | | Other Postretirement Benefits | |
|--------------------------------|------------------|-------|-------------------------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Discount rate | 5.27% | 6.18% | 4.40% | 5.00% |
| Expected return on plan assets | 6.50% | 8.00% | — | — |
| Rate of compensation increase | — | 5.00% | — | — |

The expected return on plan assets has been determined based on historical rates of return.

The assumed increase in health care cost trend rate at the end of 2010 was 8%, gradually decreasing to 5% by the year 2024 and is expected to remain at that level thereafter. A one percentage point increase or decrease in these trend rates would not have a significant effect on the accumulated benefit obligation at December 31, 2010 and the net periodic pension and other postretirement benefits cost for 2010.

Plan Assets

Assets are primarily invested in the General Account of Principal Mutual Life Insurance Company, which provides the contract and cashout value of the account. The Company's defined benefit plan investment strategy is to invest the assets in a conservative portfolio that provides an acceptable return with low down-side risk. Preservation of capital is of primary importance. The funds are invested principally in guaranteed investment contracts which are reinvested in new contracts upon expiration. The General Investment Account is a low-risk fixed income investment, consistent with the defined benefit plan's strategy. The breakdown of the cashout value of the assets as of December 31, 2010 and 2009 is as follows:

| | 2010 | 2009 |
|----------------------------|-------|-------|
| General Investment Account | 94.7% | 96.0% |
| Principal Financial Group | | |
| Stock Separate Account | 5.3% | 4.0 % |

Cash Flows

Benefit payments, which reflect expected future service, as appropriate, expected to be paid for the next ten years are as follows:

| Years Ending December 31, | Pension Benefits | Other Postretirement Benefits |
|---------------------------|------------------|-------------------------------|
| 2011 | \$ 364,000 | \$ 47,300 |
| 2012 | 374,000 | 42,100 |
| 2013 | 382,500 | 37,700 |
| 2014 | 396,400 | 34,000 |
| 2015 | 409,700 | 30,900 |
| 2016-2020 | 2,197,900 | 120,000 |
| | \$4,124,500 | \$312,000 |

Substantially all non-union salaried employees of the Company were covered by another defined contribution pension plan. Contributions under the plan were based on specified percentages of the compensation of covered employees less forfeitures, if any. There is no unfunded past service cost for this plan. In January 2010, the Company terminated the plan and offered its employees covered by this plan to fully participate in the Company's 401K Plan discussed in the following paragraph. Pension expense for this plan was approximately \$0 and \$997,000 for the years ended December 31, 2010 and 2009, respectively.

In connection with the aforementioned curtailment of the defined benefit pension plan, effective December 1, 1996 and the curtailment of the defined contribution plan discussed above, the Company established a 401(k) savings plan covering all eligible employees. Under the plan, employees may contribute up to certain percentages of their pretax

earnings, subject to the Internal Revenue Service annual contribution limit. The Company can make non-matching and matching contributions for all eligible employees. Company contributions to the plan amounted to approximately \$622,000 and \$273,000 for the years ended December 31, 2010 and 2009, respectively.

13. RELATED PARTY TRANSACTIONS

In 1968, the Company entered into an agreement with Ready Alarm, Inc. ("Ready") which provides for the sale to Ready of alarm systems installed prior to November 1, 1967 in the premises of a substantial portion of the Company's subscribers. In 1970, Ready was acquired by United Telephone Services, Inc. ("United"), all of the outstanding shares of which are owned by the Chairman of the Company, members of his family and family trusts. There have been no sales of alarm systems to Ready since its acquisition by United in 1970.

Pursuant to a United shareholders' agreement, all shares of the Company owned by United and present shareholders of United, which represent approximately 50% of the outstanding shares of the Company, are voted as directed by the Chairman.

The Company received approximately \$134,000 and \$137,000 in 2010 and 2009, respectively, for central station protection services rendered to Ready's subscribers under a contract expiring in June 2011.

A member of the board of directors is a shareholder in the insurance agency that the Company uses to place its insurance. Premiums incurred were approximately \$1,230,000 and \$1,262,000 in 2010 and 2009, respectively. The placement of insurance coverage and resulting premiums are subject to independent third party review.

14. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company measures fair value as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering assumptions, generally accepted accounting principles establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date:

- **Level 1**—Observable inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

- *Level 2*—Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the same term of the financial instrument; and
- *Level 3*—Unobservable inputs to the valuation methodology in which there is little or no market data and which are significant to the fair value measurement.

The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and counterparty creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realized value or reflective of future values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in different estimate of fair value at the reporting date.

Cash equivalents consisting of money market funds are reported at fair value utilizing Level 1 Inputs. Derivatives are reported at fair value utilizing Level 2 Inputs. The Company obtained dealer quotations to assist it in the valuation of its interest rate swaps.

| | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|------------------------|-------------------|-------------------|-------------------|---------------------|
| Cash equivalents | \$1,046,800 | \$ — | \$ — | \$1,046,800 |
| Derivative liabilities | \$ — | \$328,665 | \$ — | \$ 328,665 |

15. NEW YORK CITY FIRE DEPARTMENT LITIGATION

In June 2008, the Company reached a settlement in an ongoing action against the New York City Fire Department. All disputed fees had been paid into an independent escrow fund pending resolution of the matter. The Company received approximately \$3,860,000 of which approximately \$2,559,000 was retained by the Company as a reimbursement of costs incurred since 1994, with the balance of approximately \$1,301,000 to be returned to the Company's customers in the form of credits against future Fire Department fees. The Company has recorded a liability of \$832,000 and \$1,073,000 at December 31, 2010 and 2009, respectively, in connection with credits issuable to its customers related to this matter.

Years Ending December 31,

| | |
|------|--------------------|
| 2011 | \$ 977,000 |
| 2012 | 416,000 |
| 2013 | 158,000 |
| 2014 | 68,000 |
| 2015 | 7,000 |
| | <u>\$1,626,000</u> |

Certain leases are renewable and substantially all leases provide for payment of various cost escalations. Rent expense for all operating leases, including motor vehicles, was approximately \$2,326,000 and \$2,383,000 for the years ended December 31, 2010 and 2009, respectively.

16. COMMITMENTS AND CONTINGENCIES**Leases**

The Company is obligated under the terms of noncancellable operating leases for office, storage and operating facilities (real property) through 2015 for approximate aggregate minimum rentals of \$1,626,000 as follows:

Other

Various claims incident to the ordinary course of business, some of which have resulted in litigation, are pending against the Company. In the opinion of management, disposition of these matters will not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

AFA Protective Systems, Inc. and Subsidiaries
REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders of
AFA Protective Systems, Inc:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income, of shareholders' equity and of cash flows present fairly, in all material respects, the financial position of AFA Protective Systems, Inc. and its subsidiaries (the "Company") at December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements 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 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

March 31, 2011
Melville, New York

AFA Protective Systems, Inc. and Subsidiaries
SELECTED FINANCIAL DATA

For Each of the Five Years in the Period Ended December 31, 2010:

| | 2010 | 2009 | 2008 | 2007 | 2006 |
|--------------------------------------|-----------------------------|--------------|-----------------------------|--------------|--------------|
| Sales | \$42,443,870 | \$48,023,623 | \$52,683,340 | \$48,465,616 | \$40,189,627 |
| Service revenues | \$29,989,431 | \$30,049,342 | \$29,123,167 | \$28,129,317 | \$26,966,472 |
| Net income | \$ 997,350 | \$ 2,155,019 | \$ 2,577,452 | \$ 1,624,457 | \$ 893,906 |
| Earnings per share | \$ 6.51 | \$ 14.05 | \$ 16.80 | \$ 10.57 | \$ 5.81 |
| Cash dividends per share | \$ 52.00 ^(a) | \$ 2.00 | \$ 22.00 ^(b) | \$ 2.00 | \$ 2.00 |
| Average number of shares outstanding | 153,278 | 153,388 | 153,435 | 153,617 | 153,959 |
| At year end: | | | | | |
| Deferred revenues | \$ 9,037,686 | \$ 9,551,039 | \$ 9,380,806 | \$ 8,587,602 | \$ 8,860,950 |
| Property, plant and equipment, net | \$ 8,672,565 | \$ 9,557,013 | \$10,096,607 | \$10,967,918 | \$11,558,288 |
| Total assets | \$29,545,513 | \$32,678,126 | \$33,485,536 | \$34,180,409 | \$33,001,671 |
| Shareholders' equity | \$ 1,503,612 ^(a) | \$ 8,762,346 | \$ 7,515,736 ^(b) | \$ 8,481,849 | \$ 7,350,835 |
| Number of shares outstanding | 153,278 | 153,278 | 153,420 | 153,497 | 153,959 |
| Book value per share | \$ 9.81 ^(a) | \$ 57.17 | \$ 48.99 ^(b) | \$ 55.26 | \$ 47.75 |

(a) The Board of Directors approved a special dividend of \$50 per share to shareholders of record on December 1, 2010 and paid on December 15, 2010.

(b) The Board of Directors approved a special dividend of \$20 per share to shareholders of record on September 15, 2008 and paid on October 15, 2008.

AFA Protective Systems, Inc. and Subsidiaries
MARKET PRICES AND DIVIDEND INFORMATION

The Company's Common Stock is traded in the over-the-counter market. The range of high and low bid quotations as provided by the National Association of Security Dealers qualified interdealer quotation medium and the amount of cash dividends paid per share for each of the quarters of the fiscal years ended December 31, 2010 and 2009 are as follows:

| Year Ended December 31, 2010 | | | |
|------------------------------|------|---------|-----------|
| Quarter | | Bid | Dividends |
| 1 | High | \$400 | \$.50 |
| | Low | 257 | |
| 2 | High | 271 | .50 |
| | Low | 263 | |
| 3 | High | 275 | .50 |
| | Low | 265 | |
| 4 | High | 300 | 50.50 |
| | Low | 240 | |
| | | \$52.00 | |

| Year Ended December 31, 2009 | | | |
|------------------------------|------|--------|-----------|
| Quarter | | Bid | Dividends |
| 1 | High | \$302 | \$.50 |
| | Low | 205 | |
| 2 | High | 250 | .50 |
| | Low | 250 | |
| 3 | High | 275 | .50 |
| | Low | 275 | |
| 4 | High | 350 | .50 |
| | Low | 255 | |
| | | \$2.00 | |

CORPORATE INFORMATION

BOARD OF DIRECTORS

Asher Bernstein

*President, Bernstein Management Corp.,
a real estate company,
New York, NY*

Stephen Hess*

*President, Hess Associates,
Manhasset, NY*

Stephen Genatt*

*President, Genatt Associates,
New Hyde Park, NY*

Richard D. Kleinman

President, AFA Protective Systems, Inc.

Robert D. Kleinman

*Chairman of the Board of Directors,
Secretary and General Counsel,
AFA Protective Systems, Inc.*

Fredric Mack

*Partner, The Mack Company,
Fort Lee, NJ*

**Members of Audit Committee*

OFFICERS

Robert D. Kleinman

*Chairman of the Board of Directors,
Chief Executive Officer, Secretary and
General Counsel*

Richard D. Kleinman

President and Chief Operating Officer

James J. Jackson

Senior Vice President, Branch Operations

Raymond S. Greenberger

*Vice President, Chief Financial Officer,
Treasurer and Assistant Secretary*

Stephen P. Hyle

*Vice President
Director of National Accounts*

David M. Kleinman

Secretary

REGISTRAR AND TRANSFER AGENT

Registrar and Transfer Company

10 Commerce Drive
Cranford, NJ 07016

INDEPENDENT AUDITORS

PricewaterhouseCoopers LLP

401 Broad Hollow Road
Melville, NY 11747

ANNUAL MEETING

The Annual Meeting of Stockholders will be held on Tuesday, June 7 at 11:30 a.m. at the Company's Corporate Headquarters, 155 Michael Drive, Syosset, New York. All stockholders are invited to attend. A formal Notice of Meeting accompanies this report.

EXECUTIVE OFFICES

155 Michael Drive
Syosset, NY 11791
(516) 496-2322

REGIONAL OFFICES

FLORIDA

1255 LaQuinta Drive
Suite 100A
Orlando, FL 32809
(407) 812-9200

13161 56th Court
Suite 201
Clearwater, FL 33760
(727) 556-2905

6535 Nova Drive
Suite 111
Davie, FL 33314
(954) 473-0022

GEORGIA

805C Franklin Court
Marietta, GA 30067
(770) 794-9000

METROPOLITAN NEW YORK

519 Eighth Avenue
New York, NY 10018
(212) 279-5000

170 Eileen Way
Syosset, NY 11791
(516) 496-2322

10 Skyline Drive
Hawthorne, NY 10532
(914) 347-5481

4 Chelsea Place
Suite 103
Clifton Park, NY 12065
(518) 447-1645

MID ATLANTIC

4643 Benson Avenue
Baltimore, MD 21227
(410) 247-8305

NATIONAL ACCOUNTS

161 Forbes Road
Suite 201
Braintree, MA 02184
(781) 848-6200

NEW ENGLAND

200 High Street
Boston, MA 02110
(617) 772-5900

20 North Plains Industrial Road
Wallingford, CT 06492
(203) 265-0202

240 Chestnut Street
Warwick, RI 02888
(401) 461-2770

NEW JERSEY

961 Joyce Kilmer Avenue
North Brunswick, NJ 08902
(732) 846-4000

520 Fellowship Road
Suite D-404
Mt. Laurel, NJ 08054
(856) 231-4242

NORTH CAROLINA

214 Rowan Street
Fayetteville, NC 28301
(910) 423-4054

1018A Morrisville Parkway
Morrisville, NC 27560
(919) 981-0630

8029 Fairview Road
Mint Hill, NC 28227
(704) 545-4531



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