**INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES**
**(Successor to KC Acquisition Corporation and Subsidiaries)**

**NOTES TO FINANCIAL STATEMENTS — *(Continued)***

**7. Income Taxes — *(Continued)***

The significant components of deferred income tax (benefit) expense are as follows:

| | For the Years Ended December 31, | | |
|---|---|---|---|
| | 2000 | 2001 | 2002 |
| Deferred tax benefit recognized as a result of change in tax status | $(4,041,576) | $ | $ |
| Deferred tax (benefit) expense | 84,875 | (368,764) | (388,766) |
| Net operating loss carryforward | (567,240) | (347,979) | 41,991 |
| Deferred income tax (benefit) expense | $(4,523,941) | $(716,743) | $(346,775) |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2002 are as follows:

| | 2001 | 2002 |
|---|---|---|
| Current deferred tax assets: | | |
| Allowance for bad debts | $ 29,405 | $ |
| Net current deferred tax assets | 29,405 | |
| Long term deferred tax assets (liabilities): | | |
| Charitable contributions carryforward | 460 | 460 |
| Dealer relationships | (3,815,810) | (3,413,685) |
| Depreciation | (44,906) | (28,860) |
| Net operating loss carryforward | 1,025,338 | 983,347 |
| Net long term deferred tax liabilities | (2,834,918) | (2,458,738) |
| Net deferred tax liabilities | $(2,805,513) | $(2,458,738) |

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate of 34% as follows:

| | December 31, | | |
|---|---|---|---|
| | 2000 | 2001 | 2002 |
| Pretax loss at statutory tax rate | (34.00%) | (34.00%) | (34.00%) |
| Effect of deferred state taxes, net of federal benefit | (2.35%) | (3.35%) | (1.94%) |
| S corporation loss | 23.80% | 20.56% | 30.02% |
| LLC income | 0.00% | (6.58%) | (0.54%) |
| Conversion to S corporation | (89.69%) | 0.00% | 0.00% |
| Non-cash compensation | 1.49% | 0.00% | 0.00% |
| Reversal of a tax liability for a tax year no longer subject to an examination | 0.00% | 0.00% | (4.22%) |
| Other, net | (5.64%) | 0.20% | (0.09%) |
| Provision (benefit) for income taxes | (106.39%) | (23.17%) | (10.77%) |

C corporation income (loss) before provision for income taxes was ($1,351,799), ($1,788,618) and ($840,936) for the years ended December 31, 2000, 2001 and 2002, respectively.

At December 31, 2002, the Company has approximately $2,458,000 of net operating loss carryforwards, which begin to expire in 2018, and approximately $8,338,000 of S corporation state net operating loss carryforwards, which begin to expire in 2018. In the event of a change in control, the net operating loss carryforwards may be subject to limitations under IRS regulations.

**INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES**
**(Successor to KC Acquisition Corporation and Subsidiaries)**

**NOTES TO FINANCIAL STATEMENTS — *(Continued)***

**7. Income Taxes — *(Continued)***

As a result of the merger of KC Acquisition with IASG during January 2003, KC Acquisition, KCF, Morlyn and Criticom will no longer be considered flow through entities to their shareholders and members and, therefore, must record current and deferred income taxes from its earnings and losses, and recognize the tax consequences of "temporary differences" between financial statement and tax basis of existing assets and liabilities. At the time of a change in tax status of an enterprise, the Company will have an additional deferred tax liability of approximately $3,600,000. This will be included in income tax expense in 2003.

**8. Loss Per Common Share**

Loss per common share is as follows:

| | December 31, 2000 | 2001 | 2002 |
|---|---|---|---|
| Numerator | | | |
| Net (loss) income | $287,813 | $(2,333,526) | $(5,647,212) |
| Denominator | | | |
| Weighted average shares outstanding | 553,808 | 553,808 | 592,785 |
| Net (loss) income per share | $ 0.52 | $ (4.21) | $ (9.53) |

**9. Commitments and Contingencies**

**Leases**

The Company is obligated under operating leases for facility, property and equipment expiring at various dates through February 2010. Rent expense amounted to $466,045, $595,333 and $635,602 for the years ended December 31, 2000, 2001 and 2002, respectively.

In addition, the Company leases telephone and computer equipment under capital leases.

Minimum future annual rental commitments under non-cancelable capital and operating leases at December 31, 2002 are as follows:

| Year | Capital | Operating |
|---|---|---|
| 2003 | $ 197,505 | $306,684 |
| 2004 | 189,950 | 244,952 |
| 2005 | 159,419 | 221,765 |
| 2006 | 64,245 | 223,030 |
| 2007 | 4,044 | 193,063 |
| Total minimum lease payments | $ 615,163 | |
| Amounts representing interest | (107,305) | |
| Present value of minimum lease payments | $ 507,858 | |

**Royalty agreement**

The Company had a trademark and sub-license agreement for the use of the Smith & Wesson name in marketing alarm systems and monitoring services. The agreement had a term of nine years and ten months that commenced on March 1, 1998 and was to expire on December 31, 2008, with certain termination provisions. The agreement required minimum royalties of $600,000 for 1999 and $700,000 per year for each year thereafter payable in quarterly installments of $175,000 beginning in the first quarter of 2000. The agreement was renegotiated in August 2000 to eliminate minimum requirements. Royalty payments were based upon actual royalties earned under the sub-lease agreement for actual new sales and existing monitoring revenues without any minimums. The Company terminated this relationship on August 31, 2002 without any

**9. Commitments and Contingencies — *(Continued)***

future commitments. Royalty expense was $505,299, $71,833 and $25,435, for the years ended December 31, 2000, 2001 and 2002, respectively.

**Litigation**

The Company is involved in litigation and various legal matters that have arisen in the ordinary course of business. The Company does not believe that the outcome of these matters will have a material effect on the Company's financial position, results of operations or cash flows.

**10. Acquisitions**

In September 2002, the Company, through a newly formed wholly owned subsidiary (Criticom-IDC), acquired 100% of the common stock of Criticom International Corporation (Criticom), a wholesale alarm monitoring business located in Minneapolis, Minnesota and acquired a 5.03% interest in Royal Thoughts, LLC, a Minnesota limited liability company engaged in the development of new monitoring applications and monitoring technologies for emerging markets. The purchase price was $4,319,087, net of cash acquired of $579,591, which consisted of $1,000,000 in cash, 155,911 shares of the Company's common stock, as well as a note totaling $685,000. Additional shares may be issued to the seller based on the future performance of Criticom. No additional shares have been awarded through December 31, 2002. The transaction was accounted for under the purchase method of accounting.

The preliminary allocation of the purchase price of $4,319,087 is as follows:

| | |
|---|---|
| Dealer relationships | $ 6,098,443 |
| Accounts receivable | 877,376 |
| Prepaid expenses and other assets | 240,996 |
| Property and equipment | 862,838 |
| Due from related party | 484,018 |
| Accounts payable and accrued expenses | (550,093) |
| Deferred revenue | (1,389,489) |
| Capital leases | (554,582) |
| Long-term debt | (1,750,420) |
| Net Assets Acquired | $ 4,319,087 |

The following proforma combined results of operations have been prepared as if the acquisition had occurred at the beginning of the year of acquisition and the beginning of the immediately preceding year.

| | For the Years Ended December 31, | |
|---|---|---|
| | 2001 (unaudited) | 2002 (unaudited) |
| Revenue: | | |
| Monitoring fees | $24,204,494 | $23,592,544 |
| Billing fees | 304,116 | 568,243 |
| Related party monitoring fees | 506,982 | 1,358,126 |
| Related party placement fees | 974,448 | 1,236,227 |
| World Trade Center disaster recovery program | | 1,945,272 |
| Total revenue | $25,990,040 | $28,700,412 |
| Income from operations | $ 782,079 | $ (714,738) |
| Loss before income taxes | $ (3,291,207) | $ (6,393,526) |
| Net loss | $ (2,588,130) | $ (5,603,769) |

INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES
(Successor to KC Acquisition Corporation and Subsidiaries)

NOTES TO FINANCIAL STATEMENTS — *(Continued)*

**10. Acquisitions — *(Continued)***

The proforma results of operations do not purport to represent what the Company's results of operations would actually have been had the acquisition been effected for the periods presented, or to predict the Company's results of operations for any future period.

In January 2002, the Company acquired certain operating assets of RTC Alarm Monitoring Services (RTC), a wholesale security system alarm monitoring business located in Roseville, California. No liabilities were assumed by the Company. The transaction was accounted for under the purchase method of accounting.

The allocation of the purchase price of $5,088,057 is as follows:

| | |
|---|---|
| Dealer relationships | $4,375,046 |
| Equipment | 500,000 |
| Accounts receivable | 213,011 |
| Net assets acquired | $5,088,057 |

The purchase price was financed with a promissory note from a related party owned by stockholders of the Company in the amount of $5,800,000 (Note 6). The Company paid a fee of $175,000 to a related party in connection with this financing. The results of RTC are included in the accompanying combined financial statements from the date of acquisition.

In October 2001, the Company acquired certain operating assets of Custom Design Security (CDS), a wholesale security system alarm monitoring business located in Sarasota, Florida. No liabilities were assumed by the Company. The transaction was accounted for under the purchase method of accounting.

The allocation of the purchase price of $1,192,117 is as follows:

| | |
|---|---|
| Dealer relationships | $1,020,448 |
| Accounts receivable | 106,669 |
| Equipment | 65,000 |
| Net assets acquired | $1,192,117 |

The purchase price was financed with debt from IASI (Note 6). The results of operations of CDS are included in the accompanying combined financial statements from the date of acquisition.

In May 2000, the Company, through a newly formed wholly owned subsidiary, acquired 99% of the common stock of Griptight Holdings, Inc., a corporation whose sole asset was the ownership of 80% of the stock of Monital. The transaction was accounted for under the purchase method of accounting. At the same time, the Company acquired 20% of the stock in Monital from an unrelated party. The purchase price of $10,695,472, net of cash acquired of $829,566, financing costs of $316,025 and all other closing costs were financed with debt of $14,141,000. In addition, a related entity owned by certain stockholders of the Company paid $1,383,370 of long-term debt, and $1,910,000 of customer contracts were transferred to that related entity. This resulted in a dividend distribution of $329,144 and a compensation charge of $197,486. The results of operations of Monital are included in the accompanying combined financial statements from the date of acquisition.

INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES
(Successor to KC Acquisition Corporation and Subsidiaries)

NOTES TO FINANCIAL STATEMENTS — *(Continued)*

**10. Acquisitions — *(Continued)***

The allocation of the purchase price of $10,695,472, is as follows:

| | |
|---|---|
| Dealer relationships | $12,770,304 |
| Goodwill | 3,836,141 |
| Accounts receivable | 768,465 |
| Property and equipment | 1,122,286 |
| Prepaid expenses and other assets | 359,056 |
| Accounts payable and accrued expenses | (803,226) |
| Deferred revenue | (1,547,392) |
| Other liabilities | (590,651) |
| Deferred tax liability | (3,836,141) |
| Long-term debt | (1,383,370) |
| Net assets acquired | $10,695,472 |

In April 2001, the Company recorded $500,000 in other income from SAI. SAI is a publicly traded corporation in the alarm monitoring industry that is unrelated to the Company. SAI and KC had entered into a merger agreement. The $500,000 represents a break up fee related to the failed merger with SAI.

In April 2002, the Company settled an outstanding legal dispute related to the failed merger of the Company and SAI. As part of the Monital acquisition, the Company obtained financing of $1,500,000 from SAI (Note 6). The funds were used to purchase Monital and pay related expenses. The note was originally due December 31, 2001 with interest of $225,000. The litigation settlement modified the note agreement and as a result $957,275 was recorded as other income for the year ended December 31, 2002. The remaining debt obligation was paid in full in December 2002.

The following proforma combined results of operations have been prepared as if the acquisition had occurred at the beginning of the year of acquisition and the beginning of the immediately preceding year.

| | For the Years Ended December 31, | |
|---|---|---|
| | (Unaudited) 2000 | (Unaudited) 1999 |
| Revenue: | | |
| Monitoring fees | $19,961,814 | $19,466,592 |
| Billing fees | 261,312 | 107,109 |
| Related party monitoring fees | 1,164,165 | 490,137 |
| Related party placement fees | 189,249 | 112,569 |
| Total revenue | $21,576,540 | $20,176,407 |
| Income (loss) from operations | $ (778,714) | $ (109,926) |
| Loss before income taxes | $ (4,509,005) | $ (2,644,021) |
| Net Income (loss) | $ 284,720 | $ (2,798,756) |

The proforma results of operations do not purport to represent what the Company's results of operations would actually have been had the acquisition been effected for the periods presented, or to predict the Company's results of operations for any future period.

**11. Related Party Transactions**

As discussed throughout the footnotes to the combined financial statements, the Company has had significant transactions with related parties. Whether the terms of these transactions would have been the same had they been between non-related parties cannot be determined.

IASG provides alarm monitoring services to related parties which are owned by stockholders of the Company. Revenue earned from these alarm monitoring services was $1,164,165, $506,982 and $1,565,017 for the years ended December 31, 2000, 2001 and 2002, respectively of which $954,615, $443,658 and $1,358,126, respectively, was from IASI.

For the period July 1, 2000 through June 30, 2001, IASG and IASI were in negotiations over alarm monitoring services provided by IASG to customers of IASI that IASI claims should have been disconnected from service. Further, IASI was in negotiations with IASG over alarm monitoring services provided subsequent to June 20, 2001. IASG granted IASI concessions on alarm monitoring services of $2,000, $993,000 and $35,000 for the years ended December 31, 2000, 2001 and 2002, respectively.

Morlyn provides due diligence and other related services to IASI. Revenue earned from these services was $189,249, $974,448 and $1,236,227 for the years ended December 31, 2000, 2001 and 2002, respectively.

The Company incurred $293,202, $329,769 and $1,284,922, respectively, in related party interest for the years ended December 31, 2000, 2001 and 2002 of which $258,556, $328,650 and $621,155, respectively, was to IASI.

IASG owns 5,000 shares of stock in a company that declared bankruptcy in 2000. The investment was in a company who obtained financing from an entity owned by certain stockholders of the Company. The original investment was $32,500 and is stated at no value in the accompanying combined balance sheets. The write down of this investment is recorded in general and administrative expenses in the 2000 combined statement of operations.

IASG provides alarm monitoring services for certain independent alarm dealers who obtain financing from IASI.

Amounts due from related parties at:

| | December 31, 2001 | December 31, 2002 |
|---|---|---|
| Integrated Alarm Services, Inc: | | |
| Monitoring fees | $ 52,796 | $ 49,928 |
| Placement fees | 414,907 | |
| Advances | 453,000 | |
| Unfunded debt service reserve | | 100,000 |
| Capital Center Credit Corp: | | |
| Advances | | 84,018 |
| Interest | | 12,662 |
| RTC Trust: | | |
| Unfunded debt service reserve | | 100,000 |
| | $920,703 | $346,608 |

INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES
(Successor to KC Acquisition Corporation and Subsidiaries)

NOTES TO FINANCIAL STATEMENTS — *(Continued)*

**11. Related Party Transactions — *(Continued)***

Amounts due to related party at:

| | December 31, 2001 | December 31, 2002 |
|---|---|---|
| McGinn, Smith: | | |
| Debt issuance cost | $ | $ 2,251 |
| Integrated Alarm Services, Inc: | | |
| Other | | 34,000 |
| Stockholder: | | |
| Advances | 140,395 | 249,049 |
| | $140,395 | $285,300 |

**12. Fair Value of Instruments**

Fair value estimates, assumptions, and methods used to estimate the fair value of the Company's financial instruments are made in accordance with the requirements of SFAS No. 107, *Disclosure about Fair Value of Financial Instruments*. The Company has used available information to derive its estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts the Company could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

The carrying values of the Company's financial instruments (including cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and deferred revenue) as of December 31, 2001 and 2002 are a reasonable estimate of their fair value due to the short-term nature of the instruments. The fair value of related party debt is not determinable since it is not negotiated at arms length. The carrying value of the Company's bank debt approximates fair value.

**13. Benefit Plans**

The Company maintained two plans that provide health, dental and life insurance benefits to all eligible employees. Medical and dental coverage under the first plan is partially self-insured by the Company and contains an excess loss insurance agreement with New England Financial. The self-insurance limit is $50,000 per occurrence per year. Insurance expense under the plan was $458,561, $390,410 and $390,200 for the years ended December 31, 2000, 2001 and 2002, respectively. The second plan provides fully insured medical, dental and life insurance coverage with Aetna — U.S. Healthcare. Insurance expense under this plan was $169,510, $242,445 and $398,801 for the years ended December 31, 2000, 2001 and 2002, respectively. Effective August 1, 2002, the Company terminated its relationship with New England Financial and transferred those employees covered under the New England Financial plan to the Aetna — U.S. Healthcare plan.

Employees of the newly acquired Criticom are provided with medical, dental and life insurance plans provided by The Principal Financial Group. These plans are fully insured and the insurance expense under the plans was $65,277 since the date of the acquisition.

The IASG 401(k) retirement plan was started by an acquired company on June 29, 1993. All employees are eligible after meeting a minimum service requirement. IASG has not made a matching contribution and, therefore, has no recorded expense.



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**14. Subsequent Events**

In January 2003 KC Acquisition was re-incorporated by merging into Integrated Alarm Services Group, Inc. and the Company acquired IASI and affiliates. IASG issued 864,192 shares of its common stock, of which 525,452 shares were issued to minority interests for a total fair value of $11,559,944 related to these acquisitions.

In January 2003, the Company's Board of Directors approved an increase in authorized shares of common stock from 2,500 shares to 100,000,000 shares and a change in par value from no par value to $.001 par value. In addition, 3,000,000 shares of preferred stock was authorized at $.001 par value.

On January 8, 2003, the Company's Board of Directors approved a 6,033 for one common stock split and on April 17, 2003, the Company's Board of Directors approved a one for two reverse common stock split, as a result, per share data has been retroactively restated for all periods presented.

**15. Financial Disclosures for the Unaudited Interim Financial Information**
**Unaudited interim financial information**

The financial information as of March 31, 2003 and for the three months ended March 31, 2003 and 2002, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments that are considered necessary for fair presentation of the Company's financial position, results of operations and cash flows for the three months ended March 31, 2003 and 2002 in accordance with accounting principles generally accepted in the United States of America.

**Acquisition of IASI**

IASI which was acquired on January 31, 2003 provides financing and capital to independent security alarm dealers throughout the United States. IASI provides working capital to the independent dealers necessary for the growth of the dealers' business and financing for acquisitions. IASI has built a vertically integrated infrastructure, capable of handling all aspects of a financing for independent alarm dealers including due diligence, billing and collections and the securitizing of alarm contracts. IASI owns a significant portfolio of residential and commercial alarm contracts and contracts assumed upon the foreclosure of loans to dealers for which it provides monitoring services (through IASG and other non-affiliated entities) to its customers.

In connection with the acquisition of IASI and affiliates, IASG issued 864,192 shares of its common stock, of which 525,452 shares were issued to minority interests for a total fair value of $11,559,944 related to these acquisitions. The predecessor cost basis in net assets acquired was approximately ($21,465,000), for which 338,740 shares of common stock were issued. The transaction was accounted for under the purchase method of accounting.

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

The allocation of the purchase price of $11,559,944 is as follows:

| (in Thousands) | January 31, 2003 |
|---|---|
| Assets: | |
| Current Assets (including cash of $8,082) | $ 10,735 |
| Intangibles other than goodwill | 41,982 |
| Goodwill | 43,015 |
| Other | 21,396 |
| Total assets | $117,128 |
| Liabilities and Stockholders' Deficit: | |
| Current liabilities | $ 16,415 |
| Long-term debt, net of current portion | 109,705 |
| Other | 913 |
| Total liabilities | 127,033 |
| Total stockholders' deficit (purchase price of $11,560, net of predecessor cost basis of $(21,465)) | (9,905) |
| Total liabilities and stockholders' deficit | $117,128 |

The allocation of the purchase price is tentative and based on management estimates of fair values. The valuation will be finalized upon the completion of an independent valuation study. The goodwill resulting from the acquisition is non-deductible for income tax purposes.

The following proforma combined results of operations have been prepared as if the acquisition had occurred at the beginning of the year of acquisition and the beginning of the immediately preceding year.

| | For the Three Months Ended March 31, | |
|---|---|---|
| | 2002 | 2003 |
| Revenue: | | |
| Monitoring fees | $ 4,948,577 | $ 6,089,790 |
| Revenue from customer accounts | 2,757,134 | 3,605,667 |
| Billing fees | 149,783 | 20,983 |
| Related party monitoring fees | 21,952 | 32,814 |
| Total revenue | $ 7,877,446 | $ 9,749,254 |
| Income (loss) from operations | (591,589) | (4,110,364) |
| Loss before income taxes | (4,142,347) | (8,814,136) |
| Net loss | $(4,042,347) | $(12,315,600) |

The proforma results of operations do not purport to represent what the Company's results of operations would actually have been had the acquisition been effected for the periods presented, or to predict the Company's results of operations for any future period.

Beginning in 1992, M&S Partners, whose two partners are principal shareholders of IASG began acquiring portfolios of home security alarm contracts from independent dealers and installers. In order to fund the portfolio acquisitions, M&S Partners formed forty-one Grantor Trusts (Trusts), in which they were the ultimate beneficiaries, each of which acquired separate portfolios of contracts. In 2001, IASI formed three LLC's (Guardian Group LLC, Palisades Group, LLC and Payne Security LLC), in which First Integrated

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

Capital Corp. ("FICC") is a 50% owner, to acquire contracts. FICC, a "C" Corporation, was formed in 1999 to purchase portfolios of contracts and provide investment banking services. These Trusts and three LLC's issued notes (debt instruments) which were collateralized by the underlying alarm monitoring contracts and their recurring monthly revenues. The Trusts and three LLC's principally served the purpose of holding the contracts and ensuring that the debt was serviced from the monthly cash flows of the contracts.

During 2002, M&S Partners formed IASI and have contributed their beneficial interests for fourteen of the forty-one Trusts for shares of common stock of IASI. They contributed their beneficial interest in the remaining Trusts, three LLC's and the FICC to IASG concurrent with the merger.

The following represent the accounting policies that IASG adopted in connection with the acquisition of IASI and other supplemental information.

**Revenue recognition**

IASI provides monitoring services to customers under contracts ranging from one to five years in duration. Such contracts are cancelable with notice sixty days prior to the contract expiration date and contain no upfront fees or set up service. Customers are notified prior to the maturity date and contracts automatically renew for an annual term if no action is taken. Revenue from customer contracts is recognized as services are provided over the related monitoring contract period when a written contract is in place and collection is probable. Services may be billed in advance on a monthly, quarterly or annual basis and amounts billed but not earned are recorded as deferred revenues. Revenues deferred are recognized on a straight line basis over the term of the service agreement as the alarm monitoring services are provided.

Interest income from dealer notes receivable is recognized using the interest method. Accrual of interest income on notes receivable is suspended when a dealer portfolio is contractually delinquent for one hundred twenty days or more. The accrual is resumed when the dealer portfolio becomes contractually current, and past due interest income is recognized at that time. Generally, IASG forecloses on delinquent accounts and takes ownership of the related contracts which collateralize the notes. Refunds are granted only upon request from the customer when a payment is made on a closed account or a payment was processed where the funds were not payable to IASG.

**Notes receivable**

IASI makes loans to dealers, which are collateralized by the dealers' portfolio of customer monitoring contracts. Loans to dealers are carried at the lower of the principal amount outstanding or the net realizable value of the portfolio underlying the loan. Loans are generally considered nonperforming if they are 120 days in arrears of contractual terms.

Management periodically evaluates the loan portfolio to assess the collectibility of dealer notes and adequacy of allowance for loan losses. Management reviews certain criteria in assessing the adequacy of the allowance for loan losses including IASI's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and current economic conditions. Loan impairment is identified when a portfolio's cash flow is materially below the minimum necessary to service the loan. In most cases, loans will be foreclosed and valued at the lower of cost (loan carrying value) or fair value of customer contracts using recent transaction prices and industry benchmarks.

Notes receivable consists of loans to dealers which are collateralized by a portfolio of individual customer monitoring contracts. When a dealer becomes delinquent, the Company generally forecloses on and takes ownership of the portfolio of customer monitoring contracts.



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**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

Contractual maturities of notes receivable as of March 31, 2003 are as follows:

| For the twelve months ending March 31, | |
|---|---|
| 2004 | $1,294,758 |
| 2005 | 1,169,588 |
| 2006 | 1,327,656 |
| 2007 | 1,424,942 |
| 2008 | 935,178 |
| 2009 and thereafter | 38,609 |
| | $6,190,731 |

At March 31, 2003 notes receivable was collateralized by contracts with a recurring monthly revenue of approximately $172,000 Interest income on notes receivables was $194,854 for the three months ended March 31, 2003 and is included in interest expense, net in the statement of operations.

**Deferred revenue — notes receivable**

Deferred revenue on notes receivables represents amounts paid by the dealers for services the Company will render in the future. In connection with the loans to dealers, the Company withholds a portion of the amount loaned to cover services for the remaining term of the contract. The deferred fees are recognized as revenues as the billing and collection services are provided to the dealers. Amounts withheld are nonrefundable.

**Customer contracts**

Customer monitoring contracts are acquired from the dealers' pre-existing portfolios of contracts or assumed upon the foreclosure on dealers' loans. These acquired customer contracts are recorded at cost which management believes approximates fair value. Customer contracts assumed as a result of foreclosure on dealer loans are recorded at the lower of cost (loan carrying value) or the fair value of customer contracts using recent transaction prices and industry benchmarks at the time of foreclosure.

Customer contracts are amortized over the term that such contracts are expected to remain a customer of the Company. The Company on an ongoing basis conducts comprehensive reviews of its amortization policy for customer contracts and, when deemed appropriate, uses an independent appraisal firm to assist in performing an attrition study.

The Company's amortization methods below consider the average estimated life and historical and projected attrition rates determined from a recent attrition study and consists of the following three portfolios:

| | Accelerated method | Period |
|---|---|---|
| Existing portfolio accounts* | 150% Declining balance | 8 years |
| Dealer acquired new accounts | 160% Declining balance | 8 years |
| Contracts assumed from dealers | 160% Declining balance | 4 years |

* For existing portfolio accounts purchased subsequent to January 31, 2003, the Company will amortize such accounts using a straight-line method over an 18 year period plus actual attrition.

In August 2001, the FASB issued SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*," which supersedes SFAS No. 121, "*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*," and the accounting and reporting provisions of APB No. 30. SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets and is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years.

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the assets to be held and used is measured by a comparison of the carrying amount of the assets with the future net cash flows expected to be generated. Cash flows of customer contracts are analyzed at the same portfolio level (existing portfolio accounts, dealer acquired new accounts and contracts assumed from dealers) that they are identified for amortization, the lowest level for which independent cash flows are identifiable. All other long-lived assets are evaluated for impairment at the Company level, using one asset grouping. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Customer contracts were recorded at fair value on January 31, 2003, the purchase date. There is no impairment of these assets at March 31, 2003.

**Intangible Assets**

Customer contracts at March 31, 2003 consist of the following:

| | Existing portfolio | Dealer acquired | Contracts assumed from dealers | Total |
|---|---|---|---|---|
| Customer contracts | $9,166,094 | $27,856,526 | $4,982,728 | $42,005,348 |
| Accumulated amortization | (292,888) | (889,200) | (330,062) | (1,512,150) |
| | $8,873,206 | $26,967,326 | $4,652,666 | $40,493,198 |

Certain customer contracts acquired upon the IASI acquisition, with a cost basis of approximately $16,600,000, are subject to optional repurchase by the seller at a discounted price. The Company is amortizing these customer contracts such that the net book value approximates the discounted repurchase option price. Such repurchase is contingent on the seller complying with certain conditions outlined in the contract purchase agreement over a six-year period.

Customer contract amortization expense for the period ended March 31, 2003 was $1,512,150.

Dealer relationships at March 31, 2003 consist of the following:

| | |
|---|---|
| Dealer relationships | $ 39,958,089 |
| Accumulated amortization | (13,509,001) |
| | $ 26,449,088 |

Estimated amortization expense of customer contracts and dealer relationships for the years ending December 31, 2003 through 2007 is as follows:

| Year | Customer Contracts | Dealer Relationships | Total |
|---|---|---|---|
| 2003 | $8,026,348 | $4,447,294 | $12,473,642 |
| 2004 | 7,922,381 | 3,777,286 | 11,699,667 |
| 2005 | 6,971,542 | 2,955,556 | 9,927,098 |
| 2006 | 5,847,301 | 2,581,858 | 8,429,159 |
| 2007 | 4,643,241 | 2,303,889 | 6,947,130 |

**15. Financial Disclosures for the Unaudited Interim Financial Information — (Continued)**

**Long-term Debt**

Long-term debt consists of the following at March 31, 2003:

| | March 31, 2003 |
|---|---|
| Related Party Promissory Notes: | |
| Promissory note payable to related party owned by stockholders of the Company in original amount of $5,800,000, maturing July 1, 2007. Aggregate monthly installments of principal and interest of approximately $129,200. Fixed interest rate of 14.31%; collateralized by financed accounts receivable. The Company is required to maintain cash with the lender of $100,000, which is restricted to be used to satisfy debt service requirements in the event the Company does not have the cash flow to service the debt. At March 31, 2003 such amount was not on deposit with the lender | $ 5,271,102 |
| Promissory note payable to related party in the original amount of $685,000 is at a fixed interest rate of 10%; $100,000 was paid on October 5, 2002, $585,000 is due in April 2004 with accrued interest | 585,000 |
| Promissory note payable to related party maturing March 15, 2004, the maturity date was extended to April 30, 2004 in March 2003. Proceeds of $3,000,000 received in October 2002. Interest is payable monthly at Bear Stearn's Broker call rate plus 2.5%. Balloon payment of principal is due at maturity | 3,000,000 |
| Promissory notes payable to Capital Center Credit Corp. ("CCCC" an entity controlled by certain shareholders and an officer of the Company) and an investment fund (managed by an investment banking firm owned by shareholders and an officer of the Company) maturing April 30, 2004. Notes issued for cash proceeds in February 2003. Interest only is payable quarterly. Principal is due at maturity | 1,301,000 |
| Promissory note payable to related party maturing January 15, 2004, the maturity date was extended to April 30, 2004 in March 2003. Proceeds of $3,000,000 received in January 2003. Interest is payable at maturity at 12% per annum. Balloon payment of principal is due at maturity | 3,000,000 |
| Due to M&S Partners, on demand | 921,991 |
| Other Notes: | |
| Promissory notes payable to one bank in original amounts totaling $32,841,000 originally maturing from March 2003 to May 2005. Aggregate monthly installments of principal and interest approximates $505,000. Fixed interest rates ranging from 8% to 12.5%. Balloon payments due of approximately $11,125,000 in March 2003 (extended to June 2004), $1,750,000 in June 2004, and $6,412,000 in May 2005; collateralized by financed accounts receivable. The Company is required to maintain cash with the lender of $800,000, which is restricted to be used to satisfy debt service requirements in the event that the Company does not have the cash flow to service the debt. At March 31, 2003, $574,146 was on deposit with the lender. Such amount is included in restricted cash and cash equivalents. The lender has required that certain amounts needed to fund the following month's debt service payment be accumulated in a reserve account. At March 31, 2003, $855,059 was accumulated in the reserve account and is classified as restricted cash and cash equivalents in these financial statements | 25,367,452 |
| $5,500,000 convertible promissory notes payable to investors maturing September 1, 2005. Aggregate quarterly interest payments of approximately $123,750. Fixed interest rate of 9.0%; collateralized by financed accounts receivable | 5,500,000 |

INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES
(Successor to KC Acquisition Corporation and Subsidiaries)

NOTES TO FINANCIAL STATEMENTS — *(Continued)*

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

| | March 31, 2003 |
|---|---|
| Notes payable to a bank in original amounts totaling $1,506,888. Aggregate monthly installments of principal and interest approximates $53,000 beginning October 1999 through November 2004 with final payments of $405,000 and $255,000 in November 2004 and December 2004, respectively. Fixed interest rate of 8.75%. These notes payable are collateralized by financed accounts receivable. The Company is required to maintain cash with the lender of $36,300, which is restricted to be used to satisfy debt service requirements in the event the Company does not have the cash flow to service the debt. Such amount is included in restricted cash and cash equivalents | $ 1,181,254 |
| The Company has notes with various lending institutions. As of March 31, 2003, the monthly installments total approximately $1,500,000, including interest. As of March 31, 2003 approximately $6,300,000 of the debt is fixed with interest at rates from 7.5% to 11.0% and approximately $16,200,000 of the debt is variable of which $3,700,000 has been fixed with an interest rate swap at 8.3%. Balloon payments are due at certain intervals and approximately $22,500,000 of the notes are collateralized by specific monitoring contracts and notes receivable | 22,547,991 |
| The Company has junior debt with monthly installments of approximately $975,000 and interest rates from 10.1% to 13.5%. Balloon payments are due at certain intervals and some of the notes are collateralized by specific monitoring contracts and notes receivable | 96,703,647 |
| | 165,379,437 |
| Less: current portion, related party | 1,683,853 |
| Less: current portion of long-term debt | 15,273,182 |
| Total | $148,422,402 |

The Company is required to maintain cash in a reserve fund, which is included in cash-restricted to fund debt service payments on the Senior Debt. Payne Security Group, LLC's Senior Debt agreement contains affirmative covenants including the timely payment of taxes and restrictive covenants including fixed charges to cash flow ratio and attrition ratio. Payne Security Group, LLC was in default of certain covenants, including the timely payment of taxes, fixed charges to cash flow and attrition ratios and on March 7, 2003 and May 9, 2003 obtained permanent waivers from the Senior Debt lender for past violations. Guardian Group, LLC's Senior Debt agreement contains certain restrictive covenants including collections as a percentage of funded recurring monthly revenues (RMR) and debt service coverage ratio. The Company was in default of the collections as a percentage of funded RMR covenant and on May 14, 2003 obtained a permanent waiver from the Senior debt lender for past violations.

In March 2002, IASI commenced a new debt offering for $27,300,000 that matures in five years and pays interest at the rate of 12%. As part of the offering, junior debt note holders of 18 trusts in the aggregate principal amount of $24,600,000 have the right to exchange such notes for notes of IASI with an equal principal amount, and those trusts assets are in the process of being transferred to IASI. As of March 31, 2003, approximately $20,900,000 of notes have been exchanged under this offering. The remaining $2,700,000 of the offering is for raising cash from new lenders. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue have been assigned to IASI.

In June 2002, IASI commenced a new debt offering for $8,000,000 that matures in one year and pays interest at the rate of 12%. As part of the offering, certain note holders of 3 trusts in the aggregate principal amount of $2,590,000 have the right to exchange such notes for notes of IASI with an equal principal amount

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

and those trusts assets are in the process of being transferred to IASI. As of March 31, 2003, approximately $2,300,000 of notes have been exchanged under this offering. As of March 31, 2003, holders of one year notes amounting to approximately $7,800,000 have agreed to extend the maturity date on their notes until April 30, 2004. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue which collateralized the notes exchanged are now assets of IASI.

In August 2002, IASI commenced a new debt offering for $25,000,000 that matures in three years and pays interest at the rate of 12%. As part of the offering, certain note holders of 7 trusts in the aggregate principal amount of $9,876,000 have the right to exchange such notes for notes of IASI with an equal principal amount, and those trusts assets have been assigned to IASI. As of March 31, 2003, approximately $8,100,000 has been exchanged under this offering. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue which collateralized the notes have been assigned to IASI.

Commencing in December 2002, IASI began offering 10% two-year promissory notes to accredited investors in the aggregate principal amount of $9,200,000. These notes were all issued by March 31, 2003. These notes are unsecured and will mature on December 15, 2004. Interest only payments are due monthly with principal due at maturity.

In May 2003, IASI issued an aggregate of $3,500,000 principal amount of promissory notes. These notes bear interest at the rate of 10%, without compounding and are repayable in December 2004. Interest is payable monthly commencing July 1, 2003.

Maturities of long-term debt (on a calendar basis) exclusive of capital leases are as follows based on revised agreements at:

| | March 31, 2003 | | |
|---|---|---|---|
| | Related Parties | Other Notes | Total |
| 2003 (nine months) | $ 1,456,288 | $ 11,461,132 | $ 12,917,420 |
| 2004 | 8,938,250 | 37,209,511 | 46,147,761 |
| 2005 | 1,306,315 | 56,260,014 | 57,566,329 |
| 2006 | 1,497,534 | 11,505,842 | 13,003,376 |
| 2007 | 880,706 | 30,298,845 | 31,179,551 |
| Thereafter | | 4,565,000 | 4,565,000 |
| | $14,079,093 | $151,300,344 | $165,379,437 |

**Liquidity**

The Company incurred a net loss of approximately $10,900,000 for the three months ended March 31, 2003 and has a stockholders' deficit of approximately $32,300,000 at March 31, 2003. The Company has a working capital deficit of approximately $16,400,000 at March 31, 2003. In connection with the acquisition of IASI and affiliates, the Company has assumed significant amounts of bank and other lender debt approximating $122,600,000 and therefore continues to have a highly leveraged structure. Certain of the debt arrangements contain monthly and quarterly restrictive financial covenants for which the Company was in violation at March 31, 2003 (see preceding section of note 15). On May 9, 2003 and May 14, 2003 the Company obtained waivers from its lenders. Absent the waivers, the related debt would have been in default and approximately $10,500,000 of long-term debt would have been reclassified to current liabilities. Future compliance with such covenants is predicated on the Company achieving its future forecasts of cash flow or assigning the cash collections of unencumbered individual customer monitoring contracts to such lenders lockbox. To ensure future compliance with the lenders, the Company has agreed to assign recurring monthly revenue to such lenders lockbox on as needed basis. Management believes based on their forecasts it is

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

probable that the available RMR, less forecasted attrition will ensure compliance of its financial debt covenants through 2003 (see "Subsequent Events").

The following supplements the Company's plan (more fully described in Note 1 under the section "Liquidity"). We believe we have the ability to service our debt and capital lease obligations coming due in 2003, whether or not we are successful in completing the initial public offering, primarily from funds generated from ongoing operations, collections of current notes receivable of $1.3 million, and recent borrowings of $12.7 million since December 31, 2002. These recent borrowings include $4.3 million borrowed from related parties and junior debt of $8.4 million, net of approximately $2.8 million distributed to Capital Center Credit Corp., (that had previously contributed capital to us) in January and February of 2003. Our cash flows forecast for 2003 indicates we will generate an amount of cash flows from operations in excess of our prior year cash flows from operations. In May 2003, the Company issued an aggregate of $3,500,000 principal amount of promissory notes. These notes bear interest at the rate of 10%. Interest is payable monthly and the principal balance is due in December 2004.

Beyond 2003, as a result of the acquisition of IASI and affiliates, the Company's cash requirements for debt service, and on-going operations have increased substantially. Debt repayment obligations are significant and increase in 2004. The Company's forecasts for 2004 indicate that the Company will be unable to generate enough cash flow from operations to pay its debt obligations. As a result, the Company will need to obtain equity financing, refinance a significant portion of its debt or significantly restructure its debt payments in order to meet its obligations. In the event the Company is unsuccessful in raising equity or restructuring debt to fund debt service, the Company may fail to comply with its covenants under certain Debt agreements. A default could result in the Company's lenders requiring immediate repayment. If adequate capital funds are not available on terms favorable to the Company, its business, financial condition, results of operations and cash flows could be materially and adversely affected.

**Income Taxes**

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate of 34% for March 31, 2002 primarily as a result of S corporation losses.

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate of 34% for March 31, 2003 primarily as a result of the impact of the conversion from S corporation to C corporation, valuation allowance, related party-administrative expense and S corporation losses.

C corporation income (loss) before provision for income taxes was ($226,071) and ($7,269,539) for the three months ended March 31, 2002 and March 31, 2003, respectively.

Additionally, prior to the acquisition of IASI, IASI had a deferred income tax asset of approximately $14,780,000 which had a full valuation allowance recorded against it. As a result of the acquisition of IASI by IASG, approximately $5,040,000 of the federal portion of IASI's valuation allowance was reversed due to IASG having approximately $5,040,000 of federal deferred tax liability to offset against. This valuation allowance reversal has been reflected in the purchase accounting.

The deferred tax liability of $830,974 represents the state deferred tax liability of IASG which can not be offset by the state deferred tax asset of IASI due to the companies being subject to state taxes in different state tax jurisdictions.

IASI's federal and state deferred tax asset in excess of IASG's federal deferred tax liability will continue to be offset by a full valuation allowance since management believes it is more likely than not that such deferred tax assets will not be realized.

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

The valuation allowances recorded on the books of IASG immediately after the acquisition of IASI was $9,742,033. During the first quarter ended March 31, 2003 this valuation allowance was increased by $1,117,614 to $10,859,646.

At March 31, 2003, the Company has approximately $13,590,000 of net operating loss carryforwards, which begin to expire in 2018. The Company's net operating losses may be limited on an annual basis pursuant to the Internal Revenue Code, due to certain changes in ownership and equity transactions.

As a result of the merger of KC Acquisition with IASG during January 2003, KC Acquisition, KCF, Morlyn and Criticom will no longer be considered flow through entities to their shareholders and members and, therefore, must record current and deferred income taxes from its earnings and losses, and recognize the tax consequences of "temporary differences" between financial statement and tax basis of existing assets and liabilities. At the time of a change in tax status of an enterprise, the Company recorded an additional deferred tax liability of approximately $3,505,000, which is included in income tax expense in 2003.

**Loss per Common Share**

The loss per common share is as follows:

| | March 31, 2002 | March 31, 2003 |
|---|---|---|
| Numerator | | |
| Net loss | $(1,569,735) | $(10,862,600) |
| Denominator | | |
| Weighted average shares outstanding | 533,808 | 1,287,389 |
| Net loss per share | $ (2.83) | $ (8.44) |

**Litigation**

In March of this year, Protection One Alarm Monitoring, Inc., a company engaged in the business of providing security and other alarm monitoring services to residential and commercial customers, brought an action against the Company in the Superior Court of New Jersey, Camden County for unspecified damages in connection with the Company's purchase of certain alarm monitoring contracts from B&D Advertising Corporation ("B&D"). B&D had previously sold alarm monitoring contracts to Protection One. As part of such sales, B&D agreed not to solicit any customers whose contracts had been purchased and to keep certain information confidential. Protection One claims that the Company's subsequent purchase of contracts from B&D constitutes tortuous interference, that the Company utilized confidential information belonging to Protection One and that Protection One had an interest in some of the contracts that the Company purchased from B&D. The Company plans to vigorously defend this claim. The Company believes the resolution of this matter will not have a material adverse effect on its financial condition, results of operations or cash flows.

In May 2003, a former employee of McGinn, Smith & Co., Inc., brought an action against the Company, as well as McGinn, Smith & Co., Inc. and M&S Partners for wrongful termination. The suit brought in the Supreme Court of the State of New York seeks damages of $10,000,000. McGinn, Smith & Co., Inc. and M&S Partners have fully indemnified the Company from any damages or legal expenses that the Company may incur as a result of the suit. This employee of McGinn, Smith & Co., Inc. was never the Company's employee and the Company plans to vigorously defend this claim. The Company believes the resolution of this matter will not have a material adverse effect on our financial condition, results of operations or cash flows.

The Company is involved in litigation and various legal matters that have arisen in the ordinary course of business. The Company does not believe that the outcome of these matters will have a material effect on the Company's financial position, results of operations or cash flows.

INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES
(Successor to KC Acquisition Corporation and Subsidiaries)

NOTES TO FINANCIAL STATEMENTS — *(Continued)*

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

**Related Party Transactions**

During February 2003, the Company made a cash payment of $1,700,000 to Capital Center Credit Corporation (CCCC) which is controlled by shareholders of the Company. Also, during March 2003, the Company assumed approximately $1,575,000 of debt from CCCC. As a result, for the quarter ended March 31, 2003, IASG recognized general and administrative expense of $3,275,000.

The Company incurred $297,207 and $424,365, respectively, in related party interest for the three months ended March 31, 2002 and March 31, 2003 of which $202,066 and $167,359, respectively, was to IASI.

The Company rents office space month to month from a related party. That related party is obligated under various leases that expire over the next two years.

Included in long-term debt (junior debt) are contract certificates held by related parties that totaled approximately $330,000 at March 31, 2003.

**Swap Arrangement**

At March 31, 2003 IASI has an interest rate SWAP arrangement (maturing March 15, 2004) to fix the interest rate at 8.3% on approximately $3,700,000 of floating rate senior debt. The interest rate SWAP does not qualify as a hedge, accordingly changes in fair value are recorded as interest expense in the statement of operations. The fair value of the SWAP at March 31, 2003 was approximately $30,000.

**Benefit Plans**

IASI formed the Integrated Alarm Systems, Inc. 401(k) Retirement Plan ("Plan") effective August 1, 2002. The recorded expense for the three months ended March 31, 2003 was approximately $5,000.

**Segment and Related Information**

In connection with the acquisition of IASI, IASG acquired IASI's financing services business. As a result, IASG believes it has two reportable segments: (1) Alarm-Monitoring wholesale services and (2) Alarm-Monitoring retail services. The reportable segments are considered by management to be strategic business units that offer different services and each of whose respective long-term financial performance is affected by similar economic conditions. IASG has determined its reportable segments based on its method of internal reporting which is used by management for making operational decisions and assessing performance.

The alarm-monitoring services segment provides monitoring services to a broad range of independent alarm-monitoring dealers. The alarm-monitoring retail services segment provides working capital to independent alarm-monitoring dealers. This is accomplished by purchasing alarm monitoring contracts from the dealer or by providing loans using the dealer's alarm monitoring contracts as collateral. IASI provides monitoring services (through IASG and other non-affiliated entities) to its customers.

The accounting policies of each of the segments are the same as those described in the summary of significant accounting policies, as outlined in note 2. Management has determined that an appropriate measure of the performance of its operating segments would be made through an evaluation of each segment's income (loss) before income taxes. Accordingly, the Company's summarized financial information regarding the Company's reportable segments is presented through income (loss) before income taxes for the three months ended March 31, 2003. Prior to January 31, 2003, the Company operated in only one segment, alarm-monitoring services. The acquisition of IASI and affiliates established the new segment, Alarm-monitoring retail services for independent alarm-monitoring dealers. Intersegment revenues have been eliminated.

Summarized financial information for the three months ended March 31, 2003, concerning the Company's reportable segments is shown in the following table:



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**INTEGRATED ALARM SERVICES GROUP, INC. AND SUBSIDIARIES**
**(Successor to KC Acquisition Corporation and Subsidiaries)**

**NOTES TO FINANCIAL STATEMENTS — *(Continued)***

**15. Financial Disclosures for the Unaudited Interim Financial Information — *(Continued)***

| | Alarm-Monitoring Wholesale Services | Alarm-Monitoring Retail Services | Consolidated Total |
|---|---|---|---|
| Net revenue from external customers | $ 6,358,452 | $ 2,405,185 | $ 8,753,637 |
| Cost of revenue (including depreciation and amortization) | 5,179,271 | 1,512,149 | 6,691,420 |
| Income (loss) from operations | 333,850 | (4,059,288) | (3,725,438) |
| Interest income | | 194,854 | 194,854 |
| Interest expense | 1,301,956 | 2,093,089 | 3,395,045 |
| Loss before income taxes | (1,227,629) | (6,217,683) | (7,445,312) |
| Total assets | 44,427,259 | 102,157,367 | 146,584,626 |
| Goodwill | 7,218,743 | 43,015,595 | 50,234,338 |
| Capital expenditures | 41,667 | 23,957 | 65,624 |
| Depreciation and amortization | 1,358,371 | 1,512,150 | 2,870,521 |

**Commitment**

In April 2003, the Company entered into a three-year contract with a committed two-year term with AT&T, Inc. for communications services. As part of that contract, the Company is required to use $780,000 per year for the first two years of the contract.

**Subsequent Events**

In April 2003, the Company assumed approximately $250,000 of debt from CCCC. Approximately $30,000 of this debt is payable to related parties. IASG will recognize a general and administrative expense of $250,000 for this transaction during April 2003.

In June 2003, we secured a $20 million account acquisition facility with LaSalle Bank N.A., which is contingent upon the completion of an initial public offering with minimum net proceeds of $115 million. The facility is available to IASG for acquisitions of security alarm companies and pools of security alarm contracts.

At May 31, 2003, the Company was not in compliance with its EBITDA bank covenant (more fully described in Note 1). On June 19, 2003, the bank extended the modification to eliminate from EBITDA from March 31, 2003 to June 30, 2003 the fees related to the Company's IPO. Based on this modification, IASG is in compliance with the EBITDA covenant. Absent such modification, approximately $23,139,000 of long-term debt would have been reclassified as a current liability. Management believes, based on its forecasts, that it will comply with the EBITDA covenant through 2003.

# INTEGRATED ALARM SERVICES, INC. AND AFFILIATES

## Combined Financial Statements
## (and Report of Independent Accountants)

## As of December 31, 2001 and 2002 and
## For The Years Ended
## December 31, 2000, 2001 and 2002

**INTEGRATED ALARM SERVICES, INC. AND AFFILIATES**

**Index**

## REPORT OF INDEPENDENT ACCOUNTANTS

To the Shareholders and Board of Directors of
Integrated Alarm Services, Inc. and Affiliates:

In our opinion, the accompanying combined balance sheets and the related combined statements of operations, changes in shareholders' and trust capital (deficiency) and cash flows present fairly, in all material respects, the financial position of Integrated Alarm Services, Inc. and its affiliates at December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 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, which 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.

As described in Notes 2, 5, 6, 8 and 12 to the combined financial statements, the Company has had significant transactions with related entities.

As described in Note 1 to the combined financial statements, the Company has retroactively restated its financial statements to reflect a change in method of amortizing certain customer contracts.

/s/ PricewaterhouseCoopers LLP

Albany, New York
March 4, 2003, except for
Note 5, as to which the dates
are March 6, 2003 and
March 7, 2003 with respect
to the second paragraph and Note 1,
as to which the date is
April 25, 2003 with respect to the
sixteenth paragraph

**INTEGRATED ALARM SERVICES, INC. AND AFFILIATES**

**COMBINED BALANCE SHEETS**
**As of December 31, 2001 and 2002**

| | 2001 | 2002 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,901,128 | $ 2,993,491 |
| Current portion of notes receivable | 1,571,662 | 1,361,626 |
| Current portion of notes receivable—related parties | 941,875 | 1,096,137 |
| Accounts receivable less allowance for doubtful accounts of $255,471 in 2001 and $242,572 in 2002 | 295,782 | 282,754 |
| Total current assets | 4,710,447 | 5,734,008 |
| Notes receivable net of current portion and reserves of $800,000 in 2001 and $470,000 in 2002 | 5,063,903 | 4,973,829 |
| Notes receivable, net of current portion—related parties | 4,384,348 | 2,376,767 |
| Customer contracts, net | 52,873,788 | 45,690,852 |
| Debt issuance costs, net | 4,242,849 | 3,583,404 |
| Restricted cash | 3,175,250 | 2,846,750 |
| Total assets | $ 74,450,585 | $ 65,205,610 |
| **LIABILITIES AND SHAREHOLDERS' AND TRUST CAPITAL (DEFICIENCY)** | | |
| Current liabilities: | | |
| Current portion of long-term debt | $ 21,602,920 | $ 14,432,185 |
| Accounts payable | — | 75,101 |
| Accounts payable—related parties | 920,703 | 49,928 |
| Accrued expenses | 729,251 | 1,744,056 |
| Accrued expenses—related party | — | 358,050 |
| Current portion of deferred revenue | 804,416 | 781,905 |
| Other liabilities | 532,118 | 366,823 |
| Total current liabilities | 24,589,408 | 17,808,048 |
| Long-term liabilities | | |
| Long-term debt, net of current portion | 77,060,098 | 99,390,470 |
| Deferred revenue, net of current portion | 482,792 | 434,025 |
| Total long-term liabilities | 77,542,890 | 99,824,495 |
| Total liabilities | 102,132,298 | 117,632,543 |
| Commitments and contingencies | | |
| Shareholders' and trust capital (deficiency) | | |
| Preferred stock, $0.001 par value, 2,000,000 shares authorized and none issued and outstanding | | |
| Common stock, $0.001 par value, 50,000,000 shares authorized and 1,544,385 shares issued and outstanding | — | 1,544 |
| Contributed (drawn) capital, net | 8,231,668 | (4,291,005) |
| Accumulated deficit | (35,913,381) | (48,137,472) |
| Total shareholders' and trust capital (deficiency) | (27,681,713) | (52,426,933) |
| Total liabilities and shareholders' and trust capital (deficiency) | $ 74,450,585 | $ 65,205,610 |

The accompanying notes are an integral part of the combined financial statements.

**INTEGRATED ALARM SERVICES, INC. AND AFFILIATES**

**COMBINED STATEMENTS OF OPERATIONS**
**For the Years Ended December 31, 2000, 2001 and 2002**

| | 2000 | 2001 | 2002 |
|---|---|---|---|
| Revenue from customer accounts | $ 8,213,537 | $11,196,087 | $ 16,537,669 |
| Interest income on loans | 1,219,025 | 1,277,157 | 1,465,191 |
| Interest income on loans—related parties | 290,745 | 478,869 | 886,280 |
| Total revenue | 9,723,307 | 12,952,113 | 18,889,140 |
| Operating expenses: | | | |
| Amortization | 4,925,236 | 5,845,301 | 8,850,386 |
| Monitoring expense | 505,863 | 387,762 | 251,669 |
| Monitoring expense—related party | 954,615 | 443,658 | 1,358,126 |
| General and administrative | — | — | 3,255,942 |
| General and administrative—related parties | 1,004,017 | 1,917,469 | 1,601,588 |
| Provision for doubtful accounts | 511,177 | 1,293,903 | 1,271,776 |
| Total operating expenses | 7,900,908 | 9,888,093 | 16,589,487 |
| Income from operations | 1,822,399 | 3,064,020 | 2,299,653 |
| Other expenses: | | | |
| Amortization of debt issuance costs | 470,687 | 594,555 | 2,667,495 |
| Interest expense | 7,139,059 | 8,233,295 | 11,856,249 |
| Net loss | $(5,787,347) | $ (5,763,830) | $(12,224,091) |

The accompanying notes are an integral part of the combined financial statements.

**INTEGRATED ALARM SERVICES, INC. AND AFFILIATES**

**COMBINED STATEMENTS OF CHANGES IN SHAREHOLDERS' AND TRUST CAPITAL (DEFICIENCY)**
**For the Years Ended December 31, 2000, 2001 and 2002**

| | Common Stock | Accumulated Deficit | Contributed Capital | Total |
|---|---|---|---|---|
| Balance, December 31, 1999 | $ — | $(24,362,204) | $ (466,084) | $(24,828,288) |
| Withdrawals, net | — | — | (1,081,435) | (1,081,435) |
| Net loss | — | (5,787,347) | — | (5,787,347) |
| Balance, December 31, 2000 | — | (30,149,551) | (1,547,519) | (31,697,070) |
| Contributions, net | — | — | 9,779,187 | 9,779,187 |
| Net loss | — | (5,763,830) | — | (5,763,830) |
| Balance, December 31, 2001 | — | (35,913,381) | 8,231,668 | (27,681,713) |
| Common stock issued of IASI | 1,544 | — | (1,543) | 1 |
| Withdrawals, net | — | — | (12,521,130) | (12,521,130) |
| Net loss | — | (12,224,091) | — | (12,224,091) |
| Balance, December 31, 2002 | $1,544 | $(48,137,472) | $ (4,291,005) | $(52,426,933) |

The accompanying notes are an integral part of the combined financial statements.

## INTEGRATED ALARM SERVICES, INC. AND AFFILIATES

### COMBINED STATEMENTS OF CASH FLOWS
**For the Years Ended December 31, 2000, 2001 and 2002**

| | 2000 | 2001 | 2002 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net loss | $ (5,787,347) | $ (5,763,830) | $ (12,224,091) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | |
| Amortization | 5,395,923 | 6,439,856 | 11,517,881 |
| Bad debts | 511,177 | 1,293,903 | 1,271,776 |
| Changes in assets and liablilties: | | | |
| Accounts receivable | (179,055) | (33,889) | (680,972) |
| Accounts payable and accounts payable—related parties | (17,943) | 918,186 | (795,674) |
| Accrued expenses and accrued expenses—related party | 173,814 | 58,133 | 1,372,855 |
| Deferred revenue | 194,706 | 739,272 | (71,278) |
| Other liabilities | 45,569 | 222,764 | (165,295) |
| Net cash provided by operating activities | 336,844 | 3,874,395 | 225,202 |
| Cash flows from investing activities: | | | |
| Purchase of customer contracts | (12,753,922) | (32,185,591) | (1,732,746) |
| Financing of customer loans | (2,877,877) | (2,793,612) | (3,241,522) |
| Financing of customer loans—related parties | (449,530) | (4,350,000) | — |
| Repayment of customer loans | 1,478,654 | 1,231,014 | 3,979,181 |
| Decrease (increase) in restricted cash | (524,250) | (1,070,000) | 328,500 |
| Net cash used in investing activities | (15,126,925) | (39,168,189) | (666,587) |
| Cash flows from financing activities: | | | |
| Issuance of IAS, Inc. common stock | — | — | 1 |
| Proceeds from debt issuance | 28,421,000 | 41,695,865 | 34,860,056 |
| Capital contributions (withdrawals), net | (1,081,435) | 9,779,187 | (7,765,849) |
| Repayment of long-term debt | (10,823,379) | (13,088,311) | (23,552,410) |
| Debt issuance costs | (814,860) | (2,799,920) | (2,008,050) |
| Net cash provided by financing activities | 15,701,326 | 35,586,821 | 1,533,748 |
| Net increase in cash and cash equivalents | 911,245 | 293,027 | 1,092,363 |
| Cash and cash equivalents at beginning of year | 696,856 | 1,608,101 | 1,901,128 |
| Cash and cash equivalents at end of year | $ 1,608,101 | $ 1,901,128 | $ 2,993,491 |
| Supplemental disclosures of cash flow information | | | |
| Interest paid | $ 6,964,195 | $ 8,121,786 | $ 11,587,277 |
| Income taxes paid | $ — | $ — | $ — |
| Supplemental disclosures of non-cash items: | | | |
| Debt assumed as a return of capital | | | $ 3,851,991 |
| Loans distributed as a return of capital | | | $ 751,786 |

The accompanying notes are an integral part of the combined financial statements.



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## INTEGRATED ALARM SERVICES, INC. AND AFFILIATES

## NOTES TO COMBINED FINANCIAL STATEMENTS

### 1. Summary of Significant Accounting Policies

**Nature of business**

Integrated Alarm Services, Inc. ("Company" or "IASI"), the successor to Integrated Alarm Services Trusts ("Trusts"), provides financing and capital to independent security alarm dealers throughout the United States. The Company provides working capital to the independent dealers necessary for the growth of the dealers' business and financing for acquisitions. The Company has built a vertically integrated infrastructure, capable of handling all aspects of a financing for independent alarm dealers including due diligence, billing and collections and the securitizing of alarm contracts. The Company owns a significant portfolio of residential and commercial alarm contracts and contracts assumed upon the foreclosure of loans to dealers.

Beginning in 1992, M&S Partners, whose two partners are principal shareholders of the Company began acquiring portfolios of home security alarm contracts from independent dealers and installers. In order to fund the portfolio acquisitions, M&S Partners formed forty-one Grantor Trusts (Trusts), in which they are the ultimate beneficiaries, each of which acquired separate portfolios of contracts. In 2001, the Company formed three LLC's (Guardian Group LLC, Palisades Group, LLC and Payne Security LLC), in which First Integrated Capital Corp. ("FICC") is a 50% owner, to acquire contracts. FICC, a "C" Corporation, was formed in 1999 to purchase portfolios of contracts and provide investment banking services. These Trusts and three LLC's issued notes (debt instruments) which were collateralized by the underlying alarm monitoring contracts and their recurring monthly revenues. The Trusts and three LLC's principally served the purpose of holding the contracts and ensuring that the debt was serviced from the monthly cash flows of the contracts. M&S Partners outsourced their back office functions for the billing and collecting of the monthly alarm monitoring fees to a related entity.

During 2002, M&S Partners formed the Company and have contributed their beneficial interests for fourteen of the forty-one Trusts for shares of common stock of the Company. They will contribute their beneficial interest in the remaining Trusts, three LLC's and the FICC to the Company concurrent with a proposed initial public offering. The assets acquired from the Trusts and three LLC's were accounted for as a business acquisition with M&S Partners predecessor basis valued at historical cost and the assets of the minority interest adjusted to fair value which approximates a $150,000 adjustment to reduce customer contracts and increase withdrawals, net.

**Liquidity**

The Company, which has a highly leveraged structure, has incurred net losses since inception and has a deficit in equity at December 31, 2002. The Company has a working capital deficit of approximately $12,000,000 at December 31, 2002. Further, the Company was in default of certain monthly and quarterly financial debt covenants (as more fully described in Note 5) and certain non-financial debt covenants and obtained permanent bank waivers for all past violations (see Note 5). Absent the waivers, the related debt would have been in default and approximately $12,000,000 of long-term debt would have been reclassed to current liabilities. Future compliance with such covenants is predicated on the Company achieving its future forecasts of cash flow or assigning the cash collections of unencumbered individual customer monitoring contracts to such lenders lockbox. To ensure future compliance with the lenders, the Company has agreed to assign recurring monthly revenue to such lenders lockbox on an as needed basis. Management believes based on their forecasts it is probable that the available RMR, less forecasted attrition, will ensure compliance of its financial debt covenants through 2003. The Company's plan to fund operating and working capital deficits is to refinance existing debt arrangements, obtain additional financing (see Notes 5 and 12) and enter into a merger agreement with KC Acquisition (see Note 12). As discussed in Note 5, the Company has refinanced certain debt from monthly principal and interest payments to interest only payments with principal due at maturity. The Company has also relied upon related party financing in 2002 and 2003 to meet its current obligations in 2002 and in the first quarter of 2003. The Company plans to continue with such refinancing efforts to improve its working capital deficit. Management believes based on past experience with refinancings that they will be successful in future refinancings. However, there can be no assurances that

**1. Summary of Significant Accounting Policies — *(Continued)***

management will be successful in consummating future refinancings or that such funding will be available if needed.

Beyond 2003, the Company's cash requirements for debt service, and on-going operations are substantial. Debt repayment obligations are significant and increase in 2004 (see Note 5). The Company's forecasts for 2004 indicate that the Company will be unable to generate enough cash flow from operations to pay its debt obligations. As a result, the Company will need to obtain equity financing, refinance a significant portion of its debt or significantly restructure its debt payments in order to meet its obligations. In the event the Company is unsuccessful in raising equity or restructuring debt to fund debt service, the Company may fail to comply with its covenants under certain Senior Debt agreements. A default could result in the Company's lenders requiring immediate repayment. If adequate capital funds are not available on terms favorable to the Company, its business, results of operations and financial condition could be materially and adversely affected.

**Principles of combined financial statements**

The combined financial statements of the Company include the accounts of the forty-one trusts established by M&S Partners, IASI, three limited liability companies and one C corporation. M&S Partners controls the Company as the majority shareholder of the Company. M&S Partners also controls the assets and operations of the C corporation and the trusts and three LLC's through Monitoring Receivable Financing Agreements (Participation Agreements) which establish M&S Partners as the portfolio manager. M&S Partners role as portfolio manager can only be terminated if certain "terminating events" occur such as failure to make timely payments on debt certificates, meet the terms of the Participation Agreement, or make false representations or warranties which have a material adverse effect on the interests of Senior Participants. All significant inter-trust and inter-company transactions and balances have been eliminated in the combination.

**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 and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Segment information**

The Company believes it operates in only one segment as more fully described under "Nature of Business."

**Comprehensive income**

No statement of comprehensive income has been included in the accompanying financial statements since the Company does not have any other comprehensive income to report.

**Cash and cash equivalents**

Cash and cash equivalents include all obligations with a maturity date of three months or less at the time of purchase. The carrying amount of cash and cash equivalents approximates fair value. As of December 31, 2002 the Company maintained approximately $2,847,000 in restricted cash accounts with lenders as required under the terms of the senior loans. Such restricted cash is available to pay debt service of the related senior

**1. Summary of Significant Accounting Policies — *(Continued)***

lender if the monthly cash flows from the Trusts and two LLC's are insufficient to cover the required debt service.

**Notes receivable**

The Company makes loans to dealers, which are collateralized by the dealers' portfolio of customer monitoring contracts. Loans to dealers are carried at the lower of the principal amount outstanding or the net realizable value of the portfolio underlying the loan. Loans are generally considered nonperforming if they are 120 days in arrears of contractual terms.

Management periodically evaluates the loan portfolio to assess the collectibility of dealer notes and adequacy of allowance for loan losses. Management reviews certain criteria in assessing the adequacy of the allowance for loan losses including the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and current economic conditions. Loan impairment is identified when a portfolio's cash flow is materially below the minimum necessary to service the loan. In most cases, loans will be foreclosed and valued at the lower of cost (loan carrying value) or fair value of customer contracts using recent transaction prices and industry benchmarks.

**Customer contracts**

Customer monitoring contracts are acquired from the dealers' pre-existing portfolios of contracts or assumed upon the foreclosure on dealers' loans. These acquired customer contracts are recorded at cost which management believes approximates fair value. Customer contracts assumed as a result of foreclosure on dealer loans are recorded at the lower of cost (loan carrying value) or the fair value of customer contracts using recent transaction prices and industry benchmarks at the time of foreclosure.

Customer contracts are amortized over the term that such contracts are expected to remain a customer of the Company. The Company on an ongoing basis conducts comprehensive reviews of its amortization policy for customer contracts and, when deemed appropriate, uses an independent appraisal firm to assist in performing an attrition study.

The Company's amortization methods below consider the average estimated life and historical and projected attrition rates determined from a recent attrition study and consists of the following three portfolios:

| | Accelerated method | |
|---|---|---|
| Existing portfolio accounts | 1.7 Declining balance | 11 years |
| Dealer acquired new accounts | Double declining balance | 12 years |
| Contracts assumed from dealers | Double declining balance | 8 years |

The Company has retroactively restated its financial statements for all periods presented to change its method of amortization utilized for existing portfolio accounts. Previously the Company amortized the cost of these customer contracts on a straight-line basis over 11 years based upon an independent attrition study. In order to better correspond the amortization of the costs of these contracts with the corresponding expected contract revenue streams, the Company has changed its method of amortizing the cost of these contracts from the straight-line method to a declining balance accelerated method over 11 years, (1.7 times the declining balance). Pursuant to the "Special Exemption for an Initial Public Distribution" of securities, the Company has elected to retroactively apply this change in accounting.

**1. Summary of Significant Accounting Policies — *(Continued)***

The effect of this change in accounting method on all years presented is as follows:

| | 2000 | 2001 | 2002 |
|---|---|---|---|
| Net loss, as previously reported | $5,694,125 | $5,235,048 | $11,728,754 |
| Increase in amortization resulting from change in accounting method | 93,222 | 528,782 | 495,337 |
| Net loss, as restated | $5,787,347 | $5,763,830 | $12,224,091 |

**Impairment of long-lived assets and long-lived assets to be disposed of**

The Company accounts for customer contracts and other long-lived assets in accordance with the provisions of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed of. SFAS No. 121 requires that the assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the assets to be held and used is measured by a comparison of the carrying amount of the assets with the future net cash flows expected to be generated. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. The Company has identified no such impairment losses in the periods presented through December 31, 2001 (see "Recent Accounting Pronouncements").

**Debt issuance costs**

Debt issuance costs represents direct costs incurred in connection with the issuance of long-term notes and certificates. The debt issuance costs are being amortized over the term (varying from one to five years) of the underlying long-term debt using the effective interest method. Amortization for the year 2002 includes approximately $730,000 of expense for debt retired before maturity.

**Deferred revenue**

Deferred revenue represents amounts paid by the dealers for services the Company will render in the future. In connection with the loans to dealers, the Company withholds a portion of the amount loaned to cover services for the remaining term of the contract. The deferred revenue fees are recognized as revenues as the billing and collection services are provided to the dealers. Such amounts withheld are nonrefundable.

**Revenue recognition**

The Company provides monitoring services to customers under contracts ranging from one to five years in duration. Such contracts are cancelable with notice sixty days prior to the contract expiration date and contain no upfront fees or set up service. Customers are notified prior to the maturity date and contracts automatically renew for an annual term if no action is taken. Revenue from customer contracts is recognized as services are provided over the related monitoring contract period when a written contract is in place and collection is probable. Services may be billed in advance on a monthly, quarterly or annual basis and amounts billed but not earned are recorded as deferred revenues.

Interest income from dealer notes receivable is recognized using the interest method. Accrual of interest income on notes receivable is suspended when a dealer portfolio is contractually delinquent for one hundred twenty days or more. The accrual is resumed when the dealer portfolio becomes contractually current, and past due interest income is recognized at that time. Generally, the Company forecloses on delinquent accounts and takes ownership of the related contracts which collateralise the notes. Refunds are granted only upon request from the customer when a payment is made on a closed account or a payment was processed where the funds were not payable to the Company.

**1. Summary of Significant Accounting Policies — *(Continued)***

**Expenses paid by shareholders of the company**

Historically, the Company has outsourced its customer billing and collection services to an entity whose shareholders are majority shareholders of the Company. Such entity has paid for such services and also paid monitoring expenses on behalf of the Company. In addition, the entity has made debt repayments on behalf of the Company. Such payments have been reflected in the accompanying combined financial statements as charges to expense or reduction of debt with a corresponding credit to contributed capital. Further, the Company has assumed debt on behalf of such entity with a corresponding amount recorded as a return of capital (see Notes 5 and 8).

**Advertising costs**

The Company has not incurred advertising costs during any of the periods presented.

**Income taxes**

The trusts of the Company are taxed as such under the Internal Revenue Code and for state income tax purposes.

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes". Under SFAS No. 109, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable for future years to differences between financial statement and tax basis of existing assets and liabilities. The effect of tax rate changes on deferred taxes is recognized in the income tax provision in the period that includes the enactment date.

**Concentration of risk**

At times, cash and cash equivalent balances held at financial institutions were in excess of federally insured limits. To mitigate this risk, the Company deposits its cash and cash equivalents with high credit, quality financial institutions. At December 31, 2001 and 2002, cash and cash equivalent balances in excess of FDIC limits approximated $2,404,000 and $4,138,000, respectively.

The Company extends credit to its customers and dealers in the normal course of business and maintains allowances for potential credit losses. The Company mitigates credit risk of dealer loans by requiring dealer customer contracts as collateral. The Company's customers and dealers are located throughout the United States; therefore, the Company does not believe a significant risk of loss from concentration of credit risk exists.

**Risks and uncertainties**

As previously discussed, the Company operates in one industry and segment. A principal element of the Company's business strategy is to acquire retail security system monitoring contracts. Purchase of such contracts involve a number of special risks, including credit worthiness of customers, early cancellation for poor service and non-renewal due to competition, all of which result in account attrition (i.e. cancellation). In addition, monitoring system failures by contracted monitoring companies could result in cancellation and a reduction in revenues from customer contracts.

**Recent accounting pronouncements**

In June 2001, Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," was issued by the Financial Accounting Standards Board (FASB). SFAS No. 141 requires the purchase method of accounting to be used for all business combinations initiated after June 30, 2001. The Company's adoption of this statement in 2002 did not have a material impact on its financial statements.

In June 2001, SFAS No. 142, "Goodwill and Other Intangible Assets," was issued by the FASB. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach.

**1. Summary of Significant Accounting Policies — *(Continued)***

The Company will be required to reassess the useful lives of all intangible assets. The Company adopted SFAS No. 142 on its effective date of January 1, 2002. The Company's adoption of this statement in 2002 did not have a material impact on its financial statements.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires the fair value of a liability for an asset retirement obligation to be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company believes the adoption of this statement will not have a material impact on its financial statements.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and the accounting and reporting provisions of APB No. 30. SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets and is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the assets to be held and used is measured by a comparison of the carrying amount of the assets with the future net cash flows expected to be generated. Cash flows of customer contracts are analyzed at the same portfolio level (existing portfolio accounts, dealer acquired new accounts and contracts assumed from dealers) that they are identified for amortization, the lowest level for which independent cash flows are identifiable. All other long-lived assets are evaluated for impairment at the Company level, using one asset grouping. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. The Company's adoption of this statement in 2002 did not have a material impact on its financial statements. The carrying value of the customer contracts was higher than the fair value of the asset at December 31, 2002, but fully recoverable based upon management's estimate of future undiscounted cash flows.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections as of April 2002." This Standard addresses a number of items related to leases and other matters and is effective for fiscal years beginning after May 15, 2002. The Company does not expect the adoption of SFAS No. 145 to have a material impact on its financial statements.

In June 2002, the FASB issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities." This Standard addresses the recognition, measurement and reporting costs that are associated with exit or disposal activities. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on its financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under the guarantee. The interpretations provisions for initial recognition and measurement should be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of both interim and annual periods that end after December 15, 2002. The Company has no guarantees and therefore believes the adoption of FIN 45 will not have a material impact on its financial statements.

In December 2002, the FASB issued SFAS No. 148 "Accounting for Stock Based Compensation—Transition and Disclosure—an amendment of FAS 123". This Statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition



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**1. Summary of Significant Accounting Policies — *(Continued)***

for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Statement has varying effective dates commencing with interim periods beginning after December 15, 2002. The Company has no stock-based compensation plans and therefore believes the adoption of this statement will not have a material effect on its financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46) "Consolidation of Variable Interest Entities—an interpretation of ARB No. 51." FIN 46 addresses consolidation of business enterprises of variable interest entities. FIN 46 is effective February 1, 2003. The Company believes the adoption of FIN 46 will not have a material impact on its financial statements.

**2. Notes Receivable**

Notes receivable consists of loans to dealers which are collateralized by a portfolio of individual customer monitoring contracts. When a dealer becomes delinquent, the Company generally forecloses on and takes ownership of the portfolio of customer monitoring contracts (see Note 3).

Contractual maturities of notes receivable are as follows:

| | December 31, 2002 | |
|---|---|---|
| | Related Parties | Other Notes |
| 2003 | $1,096,137 | $1,361,626 |
| 2004 | 1,105,814 | 1,215,625 |
| 2005 | 1,183,238 | 1,335,395 |
| 2006 | 87,715 | 1,578,733 |
| 2007 | — | 1,218,398 |
| 2008 and thereafter | — | 95,678 |
| | $3,472,904 | $6,805,455 |

Changes in the allowance for credit losses were as follows:

| | Notes Receivable |
|---|---|
| Balance at January 1, 2000 | $ 15,592,556 |
| Provision for credit losses | 511,177 |
| Accounts charged off | (16,003,733) |
| Recoveries | — |
| Balance at December 31, 2000 | 100,000 |
| Provision for credit losses | 1,293,903 |
| Accounts charged off | (593,903) |
| Recoveries | — |
| Balance at December 31, 2001 | 800,000 |
| Provision for credit losses | 577,776 |
| Accounts charged off | (907,776) |
| Recoveries | — |
| Balance at December 31, 2002 | $ 470,000 |

In early 2000, the Company foreclosed on the loans of two dealers and took ownership of their customer contracts. Upon foreclosure, the Company recorded the contracts at net realizable value of approximately

**2. Notes Receivable — *(Continued)***

$9,800,000 and the remaining $14,000,000 of notes receivable fully reserved for, along with approximately $2,000,000 of other fully reserved loans, were charged off.

At December 31, 2001 and December 31, 2002 notes receivable was collateralized by contracts with a recurring monthly revenue of approximately $330,000 and $347,000, respectively.

**3. Customer Contracts**

Customer contracts at December 31, 2001 and 2002 consist of the following:

| | | 2002 | | | |
|---|---|---|---|---|---|
| | 2001 | Existing portfolio | Dealer acquired | Contracts assumed from dealers | Total |
| Customer contracts | $ 65,059,034 | $14,339,054 | $ 41,118,233 | $11,269,197 | $ 66,726,484 |
| Accumulated amortization | (12,185,246) | (3,612,167) | (11,409,230) | (6,014,235) | (21,035,632) |
| | $ 52,873,788 | $10,726,887 | $ 29,709,003 | $ 5,254,962 | $ 45,690,852 |

During the years ended December 31, 2000, 2001 and 2002, the Company foreclosed on dealer notes receivable and received in return the related collateral consisting of customer contracts with a value of approximately $9,800,000, $11,000 and $86,000, respectively. These customer contracts were recorded at the lower of cost (loan carrying value) or the fair value using recent transaction prices and industry benchmarks for similar contracts at the time of loan default. The difference between the loan carrying value and the fair value of the customer contracts was charged to the notes receivable allowance for credit losses. Amounts charged to the notes receivable allowance for credit losses during the years ended December 31, 2000, 2001 and 2002 was $16,003,733, $593,903 and $907,776, respectively.

Certain customer contracts acquired on December 27, 2001, with a cost basis of approximately $20,247,459, are subject to optional repurchase by the seller at a discounted price. The Company is amortizing these customer contracts such that the net book value approximates the discounted repurchase option price. Such repurchase is contingent on the seller complying with certain conditions outlined in the contract purchase agreement over a six-year period. In connection with the sale, the seller and the Company entered into a services agreement, whereby the seller would perform billing and collection services on behalf of the Company for a fee of ten percent of cash collections subject to certain limitations. The seller and the Company have mutually agreed to cancel the agreement and the Company has assumed billing and collection activities effective January 1, 2003.

Customer contract amortization expense for the years ended December 31, 2000, 2001 and 2002 was $4,925,236, $5,845,301 and $8,850,386, respectively.

Estimated amortization expense of the existing portfolio of customer contract rights for calendar 2003 through 2007 is as follows:

| | |
|---|---|
| 2003 | $7,539,270 |
| 2004 | 6,403,350 |
| 2005 | 5,611,057 |
| 2006 | 5,087,575 |
| 2007 | 4,699,439 |



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INTEGRATED ALARM SERVICES, INC. AND AFFILIATES

NOTES TO COMBINED FINANCIAL STATEMENTS — *(Continued)*

**4. Debt Issuance Costs**

Debt issuance costs at December 31, 2001 and 2002 consist of the following:

| | 2001 | 2002 |
|---|---|---|
| Debt issuance costs | $ 5,718,200 | $ 7,726,250 |
| Accumulated amortization of debt issuance and offering costs | (1,475,351) | (4,142,846) |
| | $ 4,242,849 | $ 3,583,404 |

Amortization expense of debt issuance costs for the years ended December 31, 2000, 2001 and 2002 was $470,687, $594,555, and $2,667,495, respectively (see Note 8).

**5. Long-term Debt**

Long-term debt at December 31, 2001 and 2002 consists of the following:

| | 2001 | 2002 |
|---|---|---|
| **Senior Debt** — The Company has notes with various lending institutions. As of December 31, 2002, the monthly installments total approximately $1,500,000, including interest. As of December 31, 2002 approximately $13,100,000 of the debt is fixed with interest at rates from 7.5% to 11.0% and approximately $12,900,000 of the debt is variable of which $8,050,000 has been fixed with an interest rate swap at 8.3% (See Note 10). Balloon payments are due at certain intervals and approximately $26,000,000 of the notes are collateralized by specific monitoring contracts and notes receivable | $ 40,466,121 | $ 26,043,548 |
| **Junior Debt** — The Company has junior debt with monthly installments of approximately $975,000 and interest rates from 10.1% to 13.5%. Balloon payments are due at certain intervals and the notes are collateralized by specific monitoring contracts and notes receivable. | 58,196,897 | 86,857,116 |
| Due to M&S Partners, on demand | — | 921,991 |
| | 98,663,018 | 113,822,655 |
| Less current portion | 21,602,920 | 14,432,185 |
| | $ 77,060,098 | $ 99,390,470 |

At December 31, 2001 and 2002, long-term debt was collateralized by contracts and notes receivable with an aggregate carrying value of approximately $63,800,000 and $50,100,000, respectively.

Maturities of long-term debt at December 31, 2002 are as follows:

| | |
|---|---|
| 2003 | $ 14,432,185 |
| 2004 | 20,796,797 |
| 2005 | 31,860,363 |
| 2006 | 11,622,842 |
| 2007 and thereafter | 35,110,508 |
| | $113,822,655 |

The Company is required to maintain cash in a reserve fund, which is included in cash-restricted to fund debt service payments on the Senior Debt. Payne Security Group, LLC's Senior Debt agreement contains affirmative covenants including the timely payment of taxes and restrictive covenants including fixed charges to cash flow ratio and attrition ratio. In 2002, Payne Security Group, LLC was in default of certain covenants,

**5. Long-term Debt — *(Continued)***

including the timely payment of taxes, fix charges to cash flow and attrition ratios and on March 7, 2003 obtained a permanent waiver from the Senior Debt lender for past violations (see Note 1). Guardian Group, LLC's Senior Debt agreement contains certain restrictive covenants including collections as a percentage of funded recurring monthly revenues (RMR) and debt service coverage ratio. In 2002 the Company was in default of the collections as a percentage of funded RMR covenant and on March 6, 2003 obtained a permanent waiver from the Senior debt lender for past violations (See Note 1).

In March 2002, IASI commenced a new debt offering for $27,300,000 that matures in five years and pays interest at the rate of 12%. As part of the offering, junior debt note holders of 18 trusts in the aggregate principal amount of $24,600,000 have the right to exchange such notes for notes of IASI with an equal principal amount, and those trusts assets are in the process of being transferred to IASI. As of December 31, 2002, approximately $20,900,000 of notes have been exchanged under this offering. The remaining $2,700,000 of the offering is for raising cash from new lenders. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue which collateralized the notes exchanged will become assets of IASI upon completion of the offering. Notes of the Trust totaling $4,053,134 not exchanged have been redeemed for cash as of December 31, 2002.

In June 2002, IASI commenced a new debt offering for $8,000,000 that matures in one year and pays interest at the rate of 12%. As part of the offering, certain note holders of 3 trusts in the aggregate principal amount of $2,590,000 have the right to exchange such notes for notes of IASI with an equal principal amount and those trusts assets are in the process of being transferred to IASI. As of December 31, 2002, approximately $2,300,000 of notes have been exchanged under this offering. As of March 4, 2003, holders of one year notes amounting to approximately $7,800,000 have agreed to extend the maturity date on their notes until April 30, 2004. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue which collateralized the notes exchanged are now assets of IASI.

In August 2002, IASI commenced a new debt offering for $25,000,000 that matures in three years and pays interest at the rate of 12%. As part of the offering, certain note holders of 7 trusts in the aggregate principal amount of $9,876,000 have the right to exchange such notes for notes of IASI with an equal principal amount, and those trusts assets are in the process of being transferred to IASI. As of December 31, 2002, approximately $8,100,000 has been exchanged under this offering. Interest only payments are due monthly with principal due at maturity. All of the contracts and recurring monthly revenue which collateralized the notes will become assets of IASI upon completion of the offering.

Commencing in December 2002, IASI began offering 10% two-year promissory notes to accredited investors in the aggregate principal amount of $9,200,000. These notes are unsecured and will mature on December 15, 2004. Interest only payments are due monthly with principal due at maturity.

The aforementioned financings, will result in principal payments of approximately $200,000 in April 2003, $10,100,000 in April 2004, $9,200,000 in December 2004, $25,000,000 in June 2005 and $27,300,000 in March 2007. Management believes the aforementioned note exchanges between the Trusts and IASI were consummated at fair value (see Note 1).

During the year ended December 31, 2002, the Company assumed approximately $3,850,000 of debt from a related party (of which approximately $900,000 is due M&S Partners and $2,950,000 is due a non-related party), which resulted in a return of capital of a corresponding amount (See Note 8).

**6. Commitments and Contingencies**

**Leases**

The Company rents office space month to month through a related party. The leases of the related party expire at various dates. Rent expense amounted to $14,444, $18,603 and $15,855 for the years ended



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### 6. Commitments and Contingencies — *(Continued)*

December 31, 2000, 2001 and 2002, respectively. The Company intends to enter into a lease for its own office space in the near future.

**Employment agreements**

On January 3, 2003 and March 1, 2003, three key employees entered into three year employment agreements with Integrated Alarm Services Group, Inc. These agreements automatically extend for additional one year periods unless either party decides not to extend. Upon a change of control, the employees are entitled to two to three years compensation. One agreement includes an annual bonus at a guaranteed minimum of $100,000. Upon termination without cause or material change in employment terms, the employee would receive one year of compensation.

**Litigation**

The Company is involved in litigation and various legal matters which have arisen in the ordinary course of business. The Company does not believe that the outcome of these matters will have a material impact on the Company's financial position, results of operations or cash flows.

### 7. Income Taxes

For income tax purposes, the forty-one trusts are complex trusts and are consequently treated as separate taxable entities which are taxed on each trust's separate taxable income. The sole purpose of establishing the trusts was to protect the rights of the debt holders and as such were structured with the intent that they would yield little or no annual taxable income.

In addition to the trusts, the combined financial statements include three limited liability companies (LLC's) which are beneficiaries of the trusts. For federal and state income tax purposes these entities are treated as partnerships and accordingly, the income taxes or credits from earnings or losses are payable by or accrued by the members.

As the result of the trusts being treated as separate taxable entities current and deferred income taxes from each trust's earnings and losses are recorded. Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities as measured by the enacted tax rates.

During 2002, as Integrated Alarm Systems, Inc. was formed and acquired the assets of certain trusts in exchange for new debt, such exchange resulted in a new tax basis or carryover tax basis in the assets acquired equal to the new debt issued. The tax attributes of the Trusts do not carryover to the Company. The scheduling of temporary differences results in a deferred tax asset which is offset with a full valuation allowance..

There was no current income tax expense in 2000, 2001 and 2002. The significant components of deferred income tax expense (benefit) are as follows:

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2000 | 2001 | 2002 |
| Deferred tax expense (benefit) | $(3,608,181) | $ 1,142,662 | $ 3,649,683 |
| Net operating loss | — | — | (3,273,617) |
| Valuation allowance | 3,608,181 | (1,142,662) | (376,066) |
| Deferred income tax benefit | $ — | $ — | $ — |

**7. Income Taxes — *(Continued)***

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate of 39.6% in 1999 and 2000, 39.1% in 2001 and 38.6% in 2002 as follows:

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2000 | 2001 | 2002 |
| Pretax income (loss) at statutory tax rate | (39.60%) | (39.10%) | (38.60%) |
| Effect of deferred state taxes, net of federal benefit | (5.90%) | 1.91% | (1.36%) |
| Partnership and LLC (income) losses and other net allocated expenses | (16.84%) | 54.48% | 35.60% |
| Impact of change in enacted rate | 0.00% | 2.53% | .68% |
| Impact of change in entity | 0.00% | 0.00% | (2.47%) |
| Valuation allowance | 62.34% | (19.82%) | 3.08% |
| Other | 0.00% | 0.00% | 3.07% |
| Provision for income taxes | 0.00% | 0.00% | 0.00% |

The pretax income (losses) and net allocated expenses from LLC's for 2000, 2001 and 2002 are approximately $2,461,809, ($8,031,208) and ($11,272,238), respectively.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2002 are as follows:

| | 2001 | 2002 |
|---|---|---|
| Long-term deferred tax assets (liabilities) | | |
| Intangibles (notes receivable and customer contracts) | $ 13,893,403 | $ 10,243,720 |
| Net operating loss carry forward | — | 3,273,617 |
| Net long-term deferred tax assets | 13,893,403 | 13,517,337 |
| Valuation allowance | (13,893,403) | (13,517,337) |
| Net deferred tax assets | $ — | $ — |

In accordance with FASB No. 109, the Company has recorded a full valuation allowance against its deferred tax asset since it believes it is more likely than not that such deferred tax asset will not be realized. The valuation allowance at December 31, 2001 and 2002 is approximately $13,893,000 and $13,517,000, respectively. During the year ended December 31, 2001 and 2002, the valuation allowance increased (decreased) by approximately ($1,143,000) and ($376,000), respectively.

At December 31, 2002, the Company has unused Federal net operating loss carryforwards of approximately $8,405,000. The Federal net operating loss carryforwards if unused will begin to expire during the year ended December 31, 2022. In the event of a change in control, the net operating loss carryforwards may be subject to limitations under IRS regulations (see Note 12).

**8. Related Party Transactions**

**Transactions with KC and Morlyn**

As discussed below, the Company has had significant transactions with related entities which transactions have had a significant impact on the Company's financial position, results of operations and cash flows. Whether the terms of these transactions would have been the same had they been between non-related entities cannot be determined.

The Company has entered into many transactions with KC Acquisition Corporation and its subsidiaries ("KC Acquisition") and Morlyn Financial Group LLC ("Morlyn") (an entity controlled by the majority shareholder of KC Acquisition) over the past several years. Shareholders of the Company are majority

**8. Related Party Transactions — *(Continued)***

shareholders of KC Acquisition. These transactions have included purchasing wholesale monitoring services (for which KC Acquisition charged the Company $3 per month per subscriber through June 2001 and effective July 1, 2001 has charged the Company 10% of subscriber cash collections), purchasing retail subscriber contracts from dealers with KC Acquisition's assistance and making direct loans to KC Acquisition (see Note 12). The Company has also made loans to Criticom International Corporation ("Criticom") which became a wholly owned subsidiary of KC Acquisition in September 2002. Morlyn LLC an affiliate of KC Acquisition provides the Company with customer care services and other advisory services including due diligence on contract acquisitions. Commencing in September 2001, Morlyn charges the Company a weekly fee of $25,000 for customer care and certain advisory services. These transactions are summarized as follows:

| | 2000 | 2001 | 2002 |
|---|---|---|---|
| Purchase of monitoring services — KC Acquisition | $954,615 | $443,658 | $1,358,126 |
| Interest income — KC Acquisition | $258,556 | $328,650 | $ 621,155 |
| Interest income — Criticom | $ 32,189 | $150,219 | $ 265,125 |
| Advisory fees — general and administrative expense — Morlyn | $189,249 | $974,448 | $1,236,227 |

| | December 31, 2001 | December 31, 2002 |
|---|---|---|
| Notes receivable — KC Acquisition | $3,217,018 | $1,825,835 |
| Notes receivable — Criticom | $2,109,205 | $1,647,069 |
| Accounts payable — KC Acquisition | $ 505,796 | $ 49,928 |
| Accounts payable — Morlyn | $ 414,907 | $ — |
| Accrued expenses — net | $ — | $ 66,000 |

For the period July 1, 2000 through June 30, 2001, the Company and KC Acquisition were in negotiations over monitoring services provided by KC Acquisition to customers the Company claims should have been disconnected from service. Further, the Company was in negotiations with KC Acquisition over monitoring service provided subsequent to June 30, 2001 resulting in amounts paid to KC Acquisition being less than the agreed upon 10% of subscriber collections. KC Acquisition granted the Company concessions on monitoring expenses of $2,000, $993,000 and $35,000 for the years ended December 31, 2000, 2001 and 2002, respectively.

**Transactions with affiliates other than KC Acquisition (see Note 12)**

The Company rents office space month to month from a related party. That related party is obligated under various leases that expire over the next two years. Many services have been provided by related parties on a cost-sharing basis. These services have included payroll and day-to-day office expenses (including billing and collection services). The Company will obtain most of these services directly in the future.

Included in long-term debt (junior debt) are contract certificates held by related parties that totaled approximately $185,000, and $186,000 at December 31, 2001 and 2002, respectively.

An entity which is controlled by the Chairman of the Board and shareholder of the Company has assisted the Company in senior and junior debt financings. The fee charged approximated 5% to 10% of debt raised which management believes is similar to a fee that would be charged by an unrelated party. Debt issuance costs incurred and paid to such entity was $814,860, $1,027,420 and $1,708,050 for the years ended December 31, 2000, 2001 and 2002, respectively. Accrued fees payable are $292,050 at December 31, 2002.

During 2000 and 2001, IASI purchased alarm monitoring contracts from entities controlled by Messrs. McGinn and Smith, for an aggregate purchase price of $12,700,000 and $200,000, respectively. These purchased alarm monitoring contracts were combined with notes receivable purchases during 2000 and 2001 totaling $3,300,000 and $7,100,000, respectively, and placed in various trusts. These amounts were identical

**8. Related Party Transactions — *(Continued)***

to the amounts paid by affiliated entities to unrelated third parties for both the alarm monitoring contracts and notes receivable. In connection with such transactions, McGinn and Smith obtained rights to the alarm monitoring contracts and notes receivable and after a very short duration, sold the assets to the Trusts.

Expenses paid by shareholders of the Company on behalf of the Company included in the combined statements of operations are as follows:

| | 2000 | 2001 | 2002 |
|---|---|---|---|
| Monitoring expenses | $505,863 | $387,762 | $180,001 |
| Certain general and administrative expenses | $814,768 | $943,021 | $365,361 |

During the year ended December 31, 2002, the Company began to pay certain expenses out of its own cash accounts.

See Note 5 for $921,991 note payable to M&S Partners.

During 2002, M&S Partners assumed a note receivable owned by IASI (with a carrying value of approximately $800,000) which resulted in an IASI capital distribution to M&S Partners of a corresponding amount. The carrying value of the note receivable approximated its fair value at the time of distribution.

**9. Fair Value of Instruments**

Fair value estimates, assumptions, and methods used to estimate the fair value of the Company's financial instruments are made in accordance with the requirements of SFAS No. 107, "Disclosure about Fair Value of Financial Instruments". The Company has used available information to derive its estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts the Company could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

The carrying amounts of the Company's financial instruments (including cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other liabilities) as of December 31, 2001 and 2002 are a reasonable estimate of their fair value due to the short-term nature of the instruments. The carrying value of the related party debt and long-term debt are also a reasonable estimate of fair value due to the limited marketability of the debt and the yield offered on new issues.

**10. Swap Arrangement**

In 2002, the Company entered into an interest rate SWAP arrangement (maturing March 15, 2004) to fix the interest rate at 8.3% on $8,050,000 of floating rate senior debt. The interest rate SWAP does not qualify as a hedge, accordingly changes in fair value are recorded as interest expense in the statement of operations. The fair value of the SWAP at December 31, 2002 was $44,967.

**11. Retirement Plan**

IASI formed the Integrated Alarm Systems, Inc. 401(k) Retirement Plan ("Plan") effective August 1, 2002. The recorded expense for 2002 was approximately $8,000. IASI is in the process of implementing additional benefit plans.

**12. Subsequent Events**

**Sale of the Company**

The Company's shareholders have exchanged their common stock for common stock of Integrated Alarm Services Group, Inc. ("IASG") effective January 31, 2003, at which time the Company became a wholly owned subsidiary of IASG (previously known as KC Acquisition). The acquisition of the Company will be

**12. Subsequent Events — *(Continued)***

accounted for as a business acquisition with IASG's predecessor basis valued at historical cost and the assets previously owned by M&S Partners adjusted to fair value using the purchase method of accounting.

**Stock split**

On January 8, 2003, the Company's Board of Directors approved a 7721.925 for one common stock split, as a result, all share data has been retroactively restated for all periods presented.

**Related party debt**

On January 15, 2003, the Company borrowed $3,000,000 from a related party. The interest rate is 12% and the full amount of principal and interest is due on January 15, 2004, the maturity date. In March 2003, the lender extended the loan maturity to April 30, 2004. In February 2003 amounts totaling $600,000 were borrowed from an investment fund which is managed by an investment banking firm owned by shareholders and an officer of the Company. Principal is due at maturity (April 2004) with quarterly interest payments at 9% commencing June 2003. (see Note 8).

During January and February 2003 the Company entered into several transactions each of which was less than $1 million with various related parties. The net result of these transactions was the issuance of $701,000 of one year 9% notes to Capital Center Credit Corp. ("CCCC"), an entity controlled by shareholders of the Company. Interest is payable quarterly commencing June 2003 with principal due at maturity in April 2004.

**Related party note receivable**

On January 17, 2003, the Company loaned an additional $2,000,000 to KC Acquisition. The interest rate is 12% and the full amount of principal and interest is due on January 17, 2004, the maturity date (see Note 8). In March 2003, the maturity date of this loan was extended to June 15, 2005.

**Debt issuance**

During January and February 2003, the Company issued approximately $7,400,000 of two-year promissory notes to investors, substantially completing the $9,200,000 offering. (see Note 5). In addition, the Company issued $2,301,000 in 9% promissory notes during February 2003 that mature in April 2004. The portion of these notes that were issued to related parties are disclosed above (Related party debt).

**Distributions**

During January and February 2003, the Company made cash distributions of $2,820,000 to CCCC and $223,200 to other trusts for which shareholders of the Company are trustees.

**Legal Proceedings**

In March of this year, Protection One Alarm Monitoring, Inc., a company engaged in the business of providing security and other alarm monitoring services to residential and commercial customers, brought an action against the Company in the Superior Court of New Jersey, Camden County for unspecified damages in connection with the Company's purchase of certain alarm monitoring contracts from B&D Advertising Corporation ("B&D"). B&D had previously sold alarm monitoring contracts to Protection One. As part of such sales, B&D agreed not to solicit any customers whose contracts had been purchased and to keep certain information confidential. Protection One claims that the Company's subsequent purchase of contracts from B&D constitutes tortious interference, that the Company utilized confidential information belonging to Protection One and that Protection One had an interest in some of the contracts that the Company purchased from B&D. The Company plans to vigorously defend this claim. The Company believes the resolution of this matter will not have a material adverse effect on its financial condition, results of operations or cash flows.

# CRITICOM INTERNATIONAL CORPORATION

## Statements of Operations and Cash Flows
## (and Report of Independent Accountants)

## For the Nine Months Ended (unaudited) September 30, 2001 and for the Period January 1, 2002 to September 25, 2002

## REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders of
Criticom International Corporation:

In our opinion, the accompanying statements of operations and cash flows present fairly, in all material respects, the results of operations and cash flows of Criticom International Corporation for the period January 1, 2002 to September 25, 2002 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 audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which 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 audit provides a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

Albany, New York
January 13, 2003

**CRITICOM INTERNATIONAL CORPORATION**

**STATEMENTS OF OPERATIONS**
**For the Nine Months Ended (unaudited) September 30, 2001 and for the Period January 1, 2002 to September 25, 2002**

| | 2001 (Unaudited) | 2002 |
|---|---|---|
| Revenue: | | |
| Monitoring fees | $3,338,702 | $3,246,753 |
| Billing fees | 6,619 | 9,896 |
| World Trade Center Disaster Recovery Program | — | 1,946,122 |
| Total revenue | 3,345,321 | 5,202,771 |
| Cost of revenue | 2,206,194 | 3,230,179 |
| | 1,139,127 | 1,972,592 |
| Operating expenses: | | |
| Selling and marketing | 456,189 | 439,316 |
| Depreciation and amortization | 195,086 | 234,597 |
| General and administrative | 788,325 | 1,030,649 |
| Research and development | 580,505 | 210,844 |
| Total operating expenses | 2,020,105 | 1,915,406 |
| (Loss) income from operations | (880,978) | 57,186 |
| Other income | 58,913 | 92,823 |
| Related party interest expense | 53,029 | 111,125 |
| Interest expense | 58,144 | 100,757 |
| Net loss | $ (933,238) | $ (61,873) |

The accompanying notes are an integral part of the financial statements.

# CRITICOM INTERNATIONAL CORPORATION

## STATEMENTS OF CASH FLOWS
**For the Nine Months Ended (Unaudited)**
**September 30, 2001 and for the Period**
**January 1, 2002 to September 25, 2002**

| | 2001 (Unaudited) | 2002 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $(933,238) | $ (61,873) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 195,086 | 234,597 |
| Provision for bad debts | 185,000 | 63,000 |
| Changes in assets and liablilties, net of non cash transactions: | | |
| Accounts receivable | (115,880) | 351,007 |
| Prepaid expenses | (9,714) | 17,306 |
| Due from officer | 63,165 | — |
| Accounts payable and accrued expenses | (53,654) | (241,596) |
| Other assets | (24,357) | 60,193 |
| Deferred revenue | 9,961 | 15,659 |
| Net cash (used in) provided by operating activities | (683,631) | 438,293 |
| Cash flows used in investing activities: | | |
| Purchase of fixed assets | (46,325) | (85,946) |
| Net cash used in investing activities | (46,325) | (85,946) |
| Cash flows from financing activities: | | |
| Proceeds of long-term debt, related party | 425,000 | — |
| Payments of principal on long-term debt, related party | (53,847) | (280,639) |
| Payments of obligations under capital leases | (47,056) | (217,087) |
| Distribution to shareholder | — | (174,000) |
| Issuance of common stock | 6,473 | |
| Net cash provided by (used in) financing activities | 330,570 | (671,726) |
| Net decrease in cash and cash equivalents | $(399,386) | $(319,379) |
| Cash and cash equivalents at beginning of period | 462,835 | 515,290 |
| Cash and cash equivalents at end of period | $ 63,449 | $ 195,911 |
| Supplemental Disclosure of cash flow information | | |
| Interest paid | $ 111,173 | $ 365,858 |
| Income taxes paid | $ — | $ — |

The accompanying notes are an integral part of the financial statements.

**CRITICOM INTERNATIONAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**1. Description of Business**

Criticom International Corp. (Criticom), an S Corporation provides monitoring services to customers on a contract basis. Criticom provides alarm monitoring services to independent alarm dealers and other telemetry customers and offers Global Positioning Systems (GPS) technology that customers use to track various types of moveable assets. Criticom operates an Underwriters Laboratories listed call center that provides alarm receiving, processing, notification, and related services for monitoring various types of alarm systems. Alarm dealers and GPS service providers generally outsource monitoring services for subscribers of independent alarm dealers as well as GPS customers to Criticom.

**2. Summary of Significant Accounting Policies**

**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 and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Segment information**

The Company believes it operates in only one segment and industry, alarm monitoring services for its customers.

**Revenue recognition**

The Company primarily provides annual contracts for alarm and GPS monitoring, and related billing services for the subscribers of independent alarm Dealers and other customers. Such contracts contain no upfront fees or setup service. Monitoring and billing revenue is recognized as the services are provided, a written agreement is in place and collection is probable. Deferred revenue represents amounts billed and or collected for monitoring fees in advance of services being provided. Revenues deferred are recognized over the term of the service agreement as the alarm and GPS monitoring services are provided. The World Trade Center Disaster Recovery Program represents revenue received under contract with the City of New York for vehicle tracking and traffic direction services.

**Research and development**

Research and development costs are expensed as incurred. Such amounts are paid to Royal Thoughts, a limited liability company whose shareholders are the same shareholders as those of Criticom. Total research and development expenses incurred for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002 were $580,505 and $210,844, respectively.

**Property and equipment**

Property and equipment are depreciated using the straight-line method over the following estimated useful lives:

| | |
|---|---|
| Furniture, leaseholds and equipment | 3-10 years |
| Computer software | 3-5 years |

Leasehold improvements are being amortized over the shorter of the estimated useful life of the asset or lease term. Equipment under capital lease is being amortized over the lease term.

**2. Summary of Significant Accounting Policies — *(Continued)***

**Income taxes**

For federal and state income tax purposes, Criticom is an S corporation and accordingly the Company's income taxes or credits resulting from earnings or losses were payable by or accrued to its shareholders.

**Advertising costs**

The Company's policy is to expense advertising costs as incurred. Advertising expense was $23,996 and $5,880 for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002, respectively.

**Risks and uncertainties**

The Company is currently dependant on related party financing to provide working capital. Any inability to obtain future funding through related parties or third parties could adversely affect the Company's cash flow and ability to meet existing obligations.

The Company is subject to operational and regulatory risk. Liabilities may arise due to system failures and false alarms. New technologies may cause existing technologies to become obsolete. Future government or other organizational regulations and standards could have an adverse effect on the Company's operations.

**Unaudited interim financial information**

The financial information for the nine months ended September 30, 2001, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, that are considered necessary for fair presentation of the Company's operations and cash flows in accordance with accounting principles generally accepted in the United States of America.

**Recent accounting pronouncements**

In June 2001, the FASB issued SFAS No. 141, Business Combinations, which address financial accounting and reporting for business combinations and supercedes APB No. 16 Business Combinations, and SFAS No. 38, Accounting for Preacquisitions Contingencies of Purchased Enterprises. Additionally, SFAS No. 141 establishes that all business combinations in the scope of the statement are to be accounted for using the purchase method. The provisions of this statement apply to all business combinations initiated after September 30, 2001.

In August 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 requires the fair value of a liability for an asset retirement obligation to be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company does not expect the adoption of SFAS 143 to have a material effect on its combined financial statements.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and the accounting and reporting provisions of APB No. 30. SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets and is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company has identified no such impairment losses for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002.

**CRITICOM INTERNATIONAL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS — *(Continued)***

**2. Summary of Significant Accounting Policies — *(Continued)***

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections as of April 2002. This Standard addresses a number of items related to leases and other matters and is effective for fiscal years beginning after May 15, 2002. The Company does not expect the adoption of SFAS No. 145 to have a material effect on its combined financial statements.

In June 2002, the FASB issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities. This Standard addresses the recognition, measurement and reporting costs that are associated with exit or disposal activities. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material effect on its combined financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees. Including Indirect Guarantees of Indebtedness of Others". FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. The interpretation provisions for initial recognition and measurement should be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of both interim and annual periods that end after December 15, 2002. The Company has no guarantees and therefore believes the adoption of FIN 45 will not have a material impact on its financial statements.

In December 2002, the FASB issued SFAS No. 148 "Accounting for Stock Based Compensation—Transition and Dislcosure—an amendment of FAS 123". This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Statement has varying effective dates commencing with interim periods beginning after December 15, 2002. The Company has no stock-based compensation plans and therefore believes the adoption of this statement will not have a material effect on its financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46) "Consolidation of Variable Interest Entities—an interpretation of ARB No. 51." FIN 46 addresses consolidation of business enterprises of variable interest entities. FIN 46 is effective February 1, 2003. The Company believes the adoption of FIN 46 will not have a material impact on its financial statements.

**3. Property and Equipment**

Depreciation expense was $171,325 and $192,853 for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002, respectively.

Amortization expense related to computer software was $23,761 and $41,744 for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002, respectively.

**4. Commitments and Contingencies**

**Leases**

The Company is obligated under an operating lease for its premises. Rent expense amounted to $97,769 and $103,825 for the nine months ended (unaudited) September 30, 2001 and for the period January 1, 2002 to September 25, 2002, respectively.

**4. Commitments and Contingencies — *(Continued)***

**Litigation**

The Company is involved in litigation and various legal matters that have arisen in the ordinary course of business. The Company does not believe that the outcome of these matters will have a material effect on the Company's financial position, results of operations or cash flows.

**5. Related Party Transactions**

The Company incurred $53,029 and $111,125 for the nine months ended (unaudited) September 30, 2001 and the period January 1, 2002 to September 25, 2002, respectively, in related party interest expense.

**6. Benefit Plans**

The Company maintains one plan that provides health, dental, and life insurance benefits to all eligible employees. This plan is provided by Principal Insurance. Insurance expense was $162,298 and $208,921 for the nine months ended (unaudited) September 30, 2001 and the period January 1, 2002 to September 25, 2002, respectively.

**7. Sale of Business**

On September 26, 2002, Criticom was sold to KC Acquisition Corporation (KC Acquisition) for $3,539,938, net of cash acquired of $579,591, which consisted of $1,000,000 in cash, 35.29 shares of KC Acquisition's common stock as well as a note totaling $685,000.

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**22,000,000 Shares**

**Common Stock**

IASG
Integrated Alarm Services Group, Inc

**FRIEDMAN BILLINGS RAMSEY**

**STIFEL, NICOLAUS & COMPANY**
**Incorporated**

**WELLS FARGO SECURITIES, LLC**