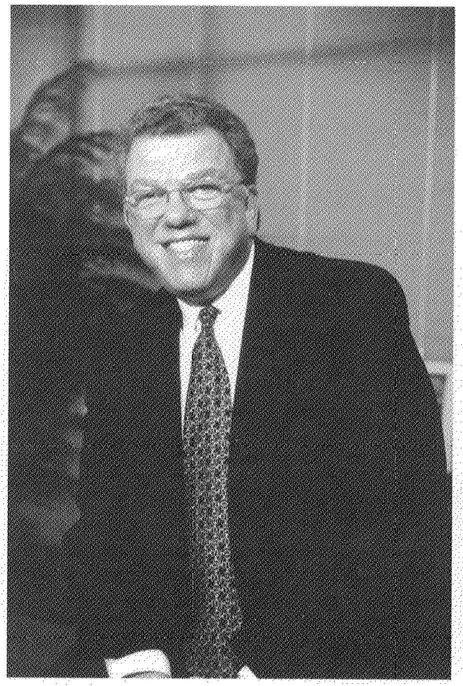
09011091

US HOME SYSTEMS

# ANNUAL REPORT

## FOR THE YEAR ENDED DECEMBER 31, 2008



Murray H. Gross
President and CEO

# U.S. Home Systems, Inc.

To Our Stockholders:

We experienced a difficult and challenging economic environment during 2008 which adversely impacted our operating results. The housing market is still very depressed, unemployment is increasing, consumers are spending less and the tightness in the consumer credit market has made it very difficult for us to arrange financing for our customers. Approximately 85% of our customers elect to utilize financing products provided principally through The Home Depot to fund their home improvement project. Customers must qualify under these programs to receive financing. In the second half of 2008 we experienced a sharp increase in the number of customers who were declined financing for their home improvement project, thereby adversely impacting our new orders. We have taken steps to address this challenge, such as reallocating marketing resources into areas of the country with more favorable credit demographics and by seeking alternative sources of financing for our customers.

On a more positive note, we remain strategically aligned with the number one home improvement brand in the US – The Home Depot. For those who may be new to US Home Systems, we renewed our service provider agreement with The Home Depot during 2008 and it runs through February, 2011. Our growth strategy is to concentrate our resources on offering products that can be distributed across the national presence of The Home Depot.

One of the key actions we took during 2008, to move our growth strategy forward, culminated in the fourth quarter of 2008. We discontinued offering our deck product. The discontinuance of this regionally based low profit margin product allows us to concentrate our resources on higher margin business that can be nationally marketed through The Home Depot system. In this respect, during the fourth quarter of 2008, we successfully concluded a pilot program in selected The Home Depot stores in the Dallas market for garage and closet organization systems.

We are now rolling out our new garage and closet home organization systems in most markets where we offer our kitchen cabinet refacing products. We expect to complete the rollout in the third quarter of 2009. We believe we are capitalizing on emerging trends that indicate that garage storage and organization is currently the fastest growing home improvement product in the marketplace. Our personnel who install our kitchen and bath systems can also install home organization products allowing us to more effectively leverage our distribution channel and our personnel.

In December, 2008, we entered into a franchise agreement with a wholly-owned subsidiary of The Home Depot, to market, sell and apply a wood kitchen cabinet and wood floor refinishing system, through selected Home Depot stores in the Boston, Massachusetts, Long Island, New York and Philadelphia, Pennsylvania markets under the brand name N-Hance. The N-Hance wood renewal system utilizes a proprietary process involving the application of cleaners, neutralizers, repair fillers, coloring agents, sealers and finishes to existing cabinet doors and drawer fronts as well as the cabinet boxes and other wood surfaces in the home, including flooring. We believe that this wood renewal system is an excellent product for customers who are looking for a more economical alternative to cabinet refacing products. It especially makes sense in the current economic climate where consumers have reigned in spending and credit has significantly tightened.

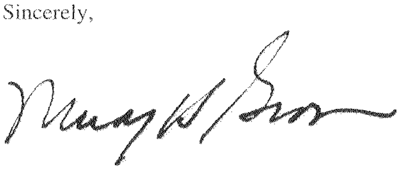
Our revenues for the year ended December 31, 2008, increased 7% to $132.5 million, from $123.3 million in 2007. Revenues from our deck products declined approximately $7.7 million for the full year 2008, reflecting the phase-out of the product offering. Our gross profit for the year was $69.6 million or 52.6% of revenues, as compared with $54.5 million, or 52.3% of revenue in 2007.

For the year ended December 31, 2008, we generated $1.4 million in operating income, as compared to $3.9 million in 2007. Net income for the year was $775,000 or $0.10 per diluted share, and this compares to a net loss of $299,000 or $0.04 per diluted share in 2007. 2007 operating results included a $2.7 million loss related to our disposition of our consumer finance business which is now classified as discontinued operations.

Although we believe the long-term outlook for the home improvement industry and our business is favorable, we expect the current weakness in the economic environment to prevail, at least in the first half of 2009. We will continue to address the current negative operating environment by focusing on our marketing strategy, and as necessary, make cost adjustments, to support our long-term objective of achieving capital appreciation for our stockholders' investment in our company. Our financial condition remains strong with about $12 million in cash and cash equivalents and $16 million in working capital at December 31, 2008. I am optimistic and confident that we will continue to make progress in 2009 in improving our business and operating results.

I want to thank our associates for their hard work and dedication during a very tough year and their commitment to the year ahead. We are appreciative of the continued support of our stockholders during this time of economic uncertainty.

Sincerely,



Murray H. Gross
President and Chief Executive Officer

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**WASHINGTON, D.C. 20549**

# FORM 10-K

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008

COMMISSION FILE NUMBER 0-18291

# U.S. HOME SYSTEMS, INC.
**(Name of Issuer Specified in Its Charter)**

| | |
|---|---|
| **Delaware** | **75-2922239** |
| **(State of Incorporation)** | **(I.R.S. Employer Identification No.)** |

| | |
|---|---|
| **405 State Highway 121 Bypass, Building A, Suite 250** | |
| **Lewisville, Texas** | **75067** |
| **(Address of Principal Executive Offices)** | **(Zip Code)** |



**(214) 488-6300**
**(Issuer's Telephone Number, Including Area Code)**

**Securities registered under Section 12 (b) of the Exchange Act:**
**$.001 Par Value Common Stock**
**(Title of Class)**

**The NASDAQ Global Market**
**(Name of each exchange on which registered)**

**Securities registered under Section 12 (g) of the Exchange Act:**
**None**
**(Title of Class)**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

As of March 10, 2009, 7,370,374 shares of the registrant's $.001 par value common stock were outstanding.

The aggregate market value of the shares of common stock held by non-affiliates of the registrant computed by reference to the closing price as of the last business day of the registrant's most recently completed second fiscal quarter, June 30, 2008, was $23,872,156.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-Accelerated Filer ☐ Smaller Reporting Company ☒

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2. Yes ☐ No ☒

The following documents are incorporated by reference: Portions of the registrant's proxy statement pertaining to the registrant's 2009 annual meeting of stockholders are incorporated by reference into Part III of this report.

## TABLE OF CONTENTS

## PART I

## CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report and the information incorporated herein by reference contain forward-looking statements that involve a number of risks and uncertainties, as well as assumptions that, if they never materialize or if they prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Although our forward-looking statements reflect the good faith judgment of our management, these statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties, and actual results and outcomes may differ materially from results and outcomes discussed in the forward-looking statements.

Forward-looking statements can be identified by the use of forward-looking words such as "believes," "expects," "hopes," "may," "will," "plans," "intends," "estimates," "could," "should," "would," "continue," "seeks" or "anticipates," or similar words (including their use in the negative), or by discussions of future matters, such as our ability to obtain new customers under our agreement with The Home Depot, sales and revenue growth, state of residential housing market, entry into new markets, expansion of our product lines, possible changes in legislation and other statements that are not historical. These statements include, but are not limited to, statements under the captions "Business," "Risk Factors," and "Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as other sections in this Annual Report. You should be aware that the occurrence of any of the events discussed under the heading "Risk Factors" and elsewhere in this Annual Report could substantially harm our business, results of operations and financial condition. If any of these events occurs, the trading price of our common stock could decline and you could lose all or a part of the value of your shares of our common stock.

The cautionary statements made in this Annual Report are intended to be applicable to all related forward-looking statements wherever they may appear in this Annual Report. We urge you not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report.

## BUSINESS

### Summary

We are engaged in the specialty product home improvement business. In our home improvement business, we manufacture or procure, design, sell and install custom kitchen and bathroom cabinet refacing products and organizational storage systems for closets and garages. We manufacture certain of our kitchen and bath cabinet refacing products at our Charles City, Virginia facility. We also maintain a marketing center in Boca Raton, Florida.

We have been a service provider for The Home Depot since 2003. In May 2006 we entered into a three year service provider agreement, or SPA, with The Home Depot. In February 2008 the termination date of the SPA was extended to February 28, 2011. Among other items, the agreement provides that we may not enter into agreements or other arrangements with any The Home Depot competitors for the marketing, sales and installation of our products. Additionally, the agreement provides that we will not offer our products and installation services in any market under any trademarks or brands other than as approved by The Home Depot. During 2008, we marketed our products under the nationally recognized brands "The Home Depot Kitchen and Bathroom Refacing" and "The Home Depot Installed Decks." Our home improvement products are marketed through a variety of sources including direct mail, marriage mail, magazines, newspaper inserts and in-store displays at selected The Home Depot stores.

Since February 2008 we and The Home Depot have been winding down offering our deck products to The Home Depot customers. Although we had planned to continue marketing our deck products under our own

Designer Deck brand in certain markets after the The Home Depot phase-out of our deck products was completed, we decided, in November 2008, to completely cease offering our deck products. Among the factors we considered in making this decision included our growth strategy to concentrate our resources on offering products that can be distributed across a wider geographic footprint with our strategic partner, The Home Depot, our expectation of continued depressed demand for deck products as a result of the softness in the housing and credit markets and the immediate challenge and expense of re-introducing our Designer Deck brand coupled with the uncertainty of consumer acceptance of our brand. At December 31, 2008, we had completed the manufacture, but not the installation, of all pending deck orders. We will continue to honor our warranty service obligations to The Home Depot customers who purchased our deck products.

Since July 2008 we and The Home Depot have been testing a pilot program in the Dallas market to offer a new range of home storage organization products for closets and the garage. We are currently working with The Home Depot to provide for a roll out of these products to be offered in markets where we currently offer our kitchen refacing products. We will begin this roll out in the first quarter of 2009 and expect to complete the roll out in the third quarter of 2009. In connection with this product category, during the second quarter of 2008, we purchased a 33.33% membership interest in Blue Viking Storage, LLC ("Blue Viking"), a distributor of garage organizer systems and accessories. In conjunction with the membership interest, we entered into a consulting agreement with Blue Viking in which Blue Viking will provide us sales and marketing consulting to support our entry and expansion into the garage and home storage industry.

In December 2008 we entered into a franchise agreement with a subsidiary company of The Home Depot which allows us to market, sell and apply a wood cabinet and wood floor refinishing system through selected The Home Depot stores in the Boston, Long Island and Philadelphia markets under the brand name of N-Hance. The N-Hance wood renewal system utilizes a proprietary process involving the application of N-Hance cleaners, neutralizers, repair/fillers, coloring agents, sealers and finishes. We intend to roll out the N-Hance wood renewal system in these markets in the first quarter of 2009.

At December 31, 2008, our home improvement business served The Home Depot in 42 markets covering 27 states. Our kitchen products are available in all 42 markets encompassing approximately 1,660 The Home Depot stores. Our bath products are currently offered in 16 markets which include approximately 523 stores. We are the sole provider of kitchen refacing products and services to The Home Depot in the United States.

Our principal offices are located at 405 State Highway 121 Bypass, Building A, Suite 250, Lewisville, Texas 75067, and our telephone number is (214) 488-6300. Our internet address is *www.ushomesystems.com.* We make available free of charge on our website at *www.ushomesystems.com* our annual, quarterly and current reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. We also post our Code of Ethics and Business Conduct on our website. However, the information found on our website is not part of this or any other report.

Our common stock is traded on the The Nasdaq Global Market System under the symbol "USHS". Except as otherwise indicated by the context, references in this Annual Report to "we", "us", "our", or the "Company" are to the combined business of U.S. Home Systems, Inc. and its subsidiaries.

**Our Business Strategy**

Our primary objective is to expand our product distribution and grow our home improvement business through our relationship with The Home Depot.

Our relationship with The Home Depot provides us with a significant distribution channel for our installed products. By combining the brand name recognition and distribution presence of The Home Depot with our manufacturing and installation programs, we believe we have the opportunity to profitably grow sales of our home improvement products. We will continue to seek opportunities to expand our relationship with The Home Depot into new geographic markets and to add new products in our The Home Depot distribution channel.

As we enter new markets under The Home Depot name, we may consider strategic acquisitions or partnerships that will provide us sales, marketing, installation or manufacturing synergies, as well as additional products, which we may be able to offer The Home Depot customers. We believe that an opportunity exists to acquire related and complementary businesses in the fragmented residential home improvement industry. The residential home improvement industry is characterized by a proliferation of small local competitors, a need for growth capital, and a potential for significant economies of scale.

## Home Improvement Business

### *Products and Services*

In our home improvement business, we manufacture or procure, design, sell and install custom quality, specialty home improvement products. Our specialty product lines include kitchen refacing, bathroom refacing and home organization storage systems for closets and garages. During the fourth quarter 2008 we ceased offering our deck products. At December 31, 2008, we had completed the manufacture, but not the installation, of all pending deck orders.

The following chart summarizes the percentage of our revenues for each of our primary product lines during the last three fiscal years.

| | Percent of Revenues Year ended December 31, | | |
|---|---|---|---|
| **Product Lines** | **2008** | **2007** | **2006** |
| Kitchen Refacing and Countertops | 83% | 75% | 69% |
| Bathroom Refacing | 7% | 8% | 9% |
| Deck Products | 10% | 17% | 22% |

*Kitchen Refacing:* Kitchen remodeling includes replacement kitchen cabinetry and kitchen cabinet refacing. Cabinet refacing is a remodeling technique in which existing cabinetry framework is retained but all exposed surfaces are changed. Under our cabinet refacing system, cabinet doors, drawers, drawer fronts, and drawer boxes are replaced, all hardware is replaced, and all exposed cabinet surfaces are covered with matching veneer or laminate. We also provide matching valances, molding, add-on or replacement cabinets, space organizers, lazy susans, slide-out shelving and countertops, which include laminate and solid-surface tops, including Corian, Silestone and granite. We purchase certain of our wood doors and wood drawer fronts from vendors and we manufacture certain cabinet doors, drawers and other cabinet refacing products in our Charles City, Virginia facility. Cabinet refacing provides consumers with a lower-cost alternative to total cabinet replacement.

As an alternative to our kitchen refacing product we intend to market, sell and apply a wood cabinet and floor refinishing system through selected The Home Depot stores under the brand name of N-Hance. The N-Hance wood renewal system can be applied at a cheaper cost than a total kitchen refacing. The wood renewal system utilizes a proprietary process involving the application of cleaners, neutralizers, repair/fillers, coloring agents, sealers and finishes. We intend to pilot this product in the Boston, Long Island and Philadelphia markets in the first quarter of 2009.

*Bathroom Refacing:* Our bathroom remodeling products include acrylic tub liners and wall surrounds, vanity cabinetry refacing and replacement vanity cabinets, bowls, faucets, commodes and shower doors. With the exception of the vanity cabinetry refacing and the replacement vanity cabinets, we purchase our bathroom remodeling products from unaffiliated suppliers and perform all installation services.

*Decks:* In February 2008, we and The Home Depot mutually agreed to terminate the installed deck program under the SPA. As a result, effective February 29, 2008, we ceased receiving customer leads from The

Home Depot for our deck products in the Midwest, Boston, Connecticut, Virginia Beach and Atlanta markets, and on October 15, 2008 we ceased receiving customer leads in our remaining deck markets, including Northern Virginia, Maryland, Philadelphia, New Jersey and New York.

We had planned to return to marketing our deck products under our own Designer Deck brand in certain markets, however, as a result of a number of factors, on November 11, 2008, we determined that we would cease offering deck products. In connection with our decision to cease offering deck products, we have recorded charges of approximately $514,000 in the fourth quarter of 2008 related to write-down of equipment assets and raw materials inventories, for severance costs and other shutdown related expenses. As of December 31, 2008, we had completed the manufacture, but not installation, of all pending deck orders. We will continue to honor our warranty service obligations to The Home Depot deck customers. We are actively marketing for sale our Woodbridge, Virginia deck manufacturing facility and equipment.

*Home Organization Products:* Our home organization product line includes garage and closet organization systems. The garage organization product offers our customers a solution for organizing their garages such that they are able to make this part of the house truly multi-functional—for parking automobiles, cleanly and efficiently store items of necessity as well as make it an activity area. This is accomplished through 'slot walls' that are installed over the existing walls and are made of heavy gauge cellular vinyl, engineered to carry heavy duty accessories. Grooves in these slot walls can provide support for hanging accessories (hooks, shelves, baskets), and cabinets provide for storage. Special purpose pre-packaged kits ('stations') cater to specific needs (such as gardening station, kids station, etc.) of families. Accessories for the ceiling offers additional storage options. Also, floor tiles made of heavy duty vinyl offer different design options to modify the look of the garage floor.

Our closet organization product provides a solution for organizing the closet space in bedrooms through a combination of shelves, drawers, hang rods and other accessories. Customers can choose from either pre-packaged configurations of 'towers' with shelves and drawers or design their own layout. Various accessories such as tie-racks, shoe-shelves, jewelry drawers, etc. offer additional options for the customers for organizing their closets.

***Marketing and Sales***

Our home improvement products are currently marketed under the nationally recognized brand "The Home Depot Kitchen and Bathroom Refacing."

Although not contractually required to promote or advertise our products, The Home Depot periodically markets our products by including them in its national and regional marketing programs. In addition, we periodically conduct advertising in other forms of media including direct mail, marriage mail, magazines and newspaper inserts.

We also maintain an in-store marketing program in which marketing promoters network with The Home Depot customers to generate customer interest in our products and schedule in-home presentations. We principally utilize an unaffiliated service provider to generate prospective customer leads for us. The service provider receives a fee for each customer who enters into a The Home Depot sales order, subject to our completion of the installation of the sales order. We provide in-store displays and full color brochures in each of The Home Depot stores which we service.

We maintain a marketing center in Boca Raton, Florida where we receive in-bound calls from potential customers in response to our and The Home Depot's advertising for our installed home improvement products. Our marketing center personnel schedule an in-home presentation with potential customers.

Our sales representatives conduct in-home sales presentations in accordance with our structured marketing programs. We utilize computer software to monitor responses and sales results of our sales staff, including tabulating results of in-home presentations on a daily basis. Such information provides data upon which we evaluate each sales representative's performance. We continually strive to improve the rate at which our sales professionals convert appointments into sales orders.

### *Manufacturing and Installation*

*Kitchen and Bath Products:* We manufacture our cabinet fronts, including cabinet doors, drawers, drawer fronts and cabinets faced with high-pressure laminate or thermo foil at our facility in Charles City, Virginia. Certain components, including countertops, wood cabinet doors, wood drawer fronts, hardware, acrylic tub liners and wall surrounds are purchased from third-party suppliers.

With the exception of our operations in California and New Jersey and occasional warranty and other service work, independent contractors who meet our qualifications perform most of our kitchen and bath installations. Contractors employ their own personnel and are required to maintain their own vehicles, equipment, tools, licenses, workers compensation coverage and general liability insurance. Contractors assume full financial risk in their performance of an installation. We issue to our contractors a work order, which specifies all work to be performed pursuant to the sales agreement, for each of our remodeling projects. The contractor can then pick up all necessary materials for the project at our local branch office. In our California, New Jersey and Pennsylvania operations, we generally utilize employee installers.

Kitchen and bath installations are generally completed within 55 to 60 days after a sales agreement is signed, and within three to five workdays from commencement of the installation. Upon completion, the installation crew obtains a certificate of completion signed by the customer and returns all documentation and excess materials to us. We pay the installer upon receipt of the completion certificate for each job. Fees paid by us to subcontractors for an installation are based upon an amount negotiated between the contractor and us. We have specific pay rates for our employee installation crews.

*Deck Products:* Since we have ceased offering our deck products, we are actively marketing for sale our Woodbridge, Virginia manufacturing facility and equipment.

*Home Organization:* Materials for our garage organization product line (slot walls, floor tiles, accessories, etc.) are primarily sourced from our business partner, Blue Viking. Materials for our closet organization products are generally purchased from one supplier, although these materials are available from several different suppliers.

### *Competition*

We face significant competition in our respective markets. Reputation, price, workmanship and level of service are among the differentiating factors within the industry. We compete with numerous home improvement contractors and home center retailers in each of the markets in which we operate, including Sears, Sam's Warehouse Club and Lowe's. As we continue our expansion programs with The Home Depot, we anticipate that we and The Home Depot will face greater competition from major home center retailers.

### *Raw Materials*

We are not dependent upon a single source for our principal raw materials, and such raw materials have, historically, been readily available. Raw materials used in the manufacturing and installation process are purchased from several suppliers at prices that are periodically negotiated. We believe that such materials are and will continue to be, available from numerous suppliers at competitive prices.

### *Warranties*

For our kitchen and bathroom products, in addition to the manufacturer's warranty for defective materials, we provide each customer a one-year limited warranty covering workmanship and a limited warranty covering defective materials. We require each of our independent contractors to correct defective workmanship for a 12-month period. Although we have discontinued offering our deck products, we will continue to honor our warranty service obligations to The Home Depot customers who purchased our deck products.

***Customer Payment***

The Home Depot customers pay The Home Depot for their home improvement products and services upon completion of the project by cash, personal checks, credit cards or financing arranged by The Home Depot. The Home Depot pays us for each installed home improvement project less a marketing fee retained by The Home Depot. Approximately 85% of our The Home Depot customers elect to utilize financing products provided principally through The Home Depot to fund their home improvement project. As a result of increased credit qualifications and the severe limitations on credit availability in the second half of 2008, we experienced an increase in the number of customers who were declined financing for their home improvement project, thereby adversely impacting our new sales orders. We are currently seeking alternative financing options for customers.

***Seasonality***

Our business is subject to seasonal trends. The generation of sales orders for our home improvement products typically declines in the last six weeks of the year during the holiday season, which negatively impacts our first quarter revenues and net income.

Extreme weather conditions in the markets we serve occasionally impact our revenues and net income.

**The Home Depot Agreement**

*The Home Depot Relationship.* We believe our relationship with The Home Depot is a significant factor to the achievement of our long-term growth. In May 2006, we entered into a three year service provider agreement, or SPA, with The Home Depot to sell and install our specialty home improvement products exclusively to The Home Depot customers in designated markets. Our principal product lines include kitchen and bathroom cabinet refacing products, including countertops and home organization systems for bedroom closets and garages. We are currently the sole provider of kitchen cabinet refacing products and service to The Home Depot in the United States.

On February 28, 2008, we and The Home Depot mutually agreed to extend the termination date of the SPA to February 28, 2011 and terminate the installed deck program under the SPA. At December 31, 2008, we had completed the manufacture, but not installation, of all of the pending deck orders for The Home Depot customers. We will continue to honor our warranty service obligations to The Home Depot customers who purchased our deck products.

In July 2008 we began testing a pilot program in the Dallas market to offer a new range of home storage organization products for closets and garages. We are currently working with the The Home Depot to provide a roll out of these products to be offered in markets where we currently offer our kitchen refacing products. We will begin this product roll out in the first quarter of 2009 and expect to have the roll out completed during the third quarter of 2009.

In December 2008 we entered into a franchise agreement with a subsidiary of The Home Depot which allows us to market, sell and apply a wood cabinet and floor refinishing system through selected The Home Depot stores in the Boston, Long Island and Philadelphia markets under the brand name of N-Hance. The N-Hance wood renewal system utilizes a proprietary process involving the application of N-Hance cleaners, neutralizers, repair/fillers, coloring agents, sealers and finishes. We intend to roll out the N-Hance wood renewal system in these markets in the first quarter of 2009.

At December 31, 2008 our home improvement business served the The Home Depot in 42 markets covering 27 states. Our kitchen products are available in all 42 markets encompassing approximately 1,660 The Home Depot stores. Our bath products are offered in 17 markets which include approximately 567 stores.

The following is a summary of material terms and conditions of the SPA, as amended:

*Term.* The SPA was effective on May 1, 2006 and shall continue until February 28, 2011 unless earlier terminated consistent with the provisions of the SPA.

*Termination.* We or The Home Depot may, upon not less than 180 calendar days' prior written notice to the other party, terminate the SPA at any time. If The Home Depot is the terminating party due to its desire to discontinue the marketing and installation of the products offered by us, The Home Depot shall continue to refer customer leads to us for a period of six months following the date of the notice of termination. During the 180 day period, we may continue marketing our products and shall be allowed to enter into contractual arrangements with any The Home Depot competitors. Further, we shall be allowed to begin marketing and installing our products under other national brands, including our company brands. If The Home Depot is the terminating party, due to its desire to transition to another service provider, The Home Depot shall continue to refer leads in each market being served by us until the replacement service provider is able to cover 60% of such market. The provisions of the SPA restricting us from entering into a contractual arrangement with a The Home Depot competitor shall remain in force until the replacement service provider is able to cover 60 % of the market. The SPA may be terminated by either party with 30 days written notice upon a breach by either party of any obligation under the SPA, if such breach is not remedied within 30 days.

If we are the terminating party, we are obligated to timely complete all uncompleted projects, pay all sums owed to The Home Depot and refrain from entering into any agreements with The Home Depot competitors until the termination date.

To ensure fulfillment of our obligations upon termination of the SPA, The Home Depot may for a period of 90 calendar days following the date of notice of termination of the SPA, or for a period of 60 calendar days following the date of termination or expiration of the SPA, which ever period is greater, delay payment of up to 15% of outstanding invoices or a maximum of $2 million that would otherwise be due us under the SPA.

*Exclusivity.* During the term of the SPA, we have agreed not to enter into any agreement or other arrangement with The Home Depot competitors relating to the marketing, selling or providing of our products and installation services. We have also agreed to refrain from offering, directly or indirectly, our products and installation services in any The Home Depot market, including markets that have not been assigned to us by The Home Depot, under any trademarks or brands other than expressly approved by The Home Depot. The Home Depot has agreed not to use any service provider in any markets awarded to us to perform the same or similar services, or provide similar products, as those that may be provided by us under the SPA.

*Marketing.* Although not required by the terms of the SPA, The Home Depot assists us with the marketing of our products and services by including them in its marketing programs and by providing us with sales leads generated by our in-store displays and The Home Depot marketing programs. We provide the in-store displays of our products and services, and training to The Home Depot sales personnel for marketing of our products and services, and we follow up sales leads with in-home visits to potential customers. Sales contracts generated from our in home visits are between the customer and The Home Depot. However, we provide the products, labor and installation services necessary to complete customer orders generated from The Home Depot sales leads and we are required to make necessary repairs to address any customer complaints or warranty claims. The SPA provides that The Home Depot will receive a marketing fee on each sales contract.

*Trademarks.* Each party has been granted a non-exclusive, royalty-free, revocable license, with certain restrictions, to use the other parties specified trademarks, trade name and logos in the marketing and installation of our products, which includes our "Designer Deck" and "Facelifters" trademarks. We have agreed that The Home Depot may use our "Facelifters" mark solely in connection with the advertising, marketing, displaying and merchandising by The Home Depot of cabinet refacing products and services.

If the SPA is terminated by The Home Depot for any reason or is not renewed by The Home Depot, the right and license granted to The Home Depot for the "Facelifters" mark shall be revoked. However, The Home Depot shall, at its option, have the right on a non-exclusive and non-fee basis to continue to use the "Facelifters" mark for a period of up to 12 months after such termination date. Thereafter, The Home Depot shall cease using the "Facelifters" mark for any purpose.

If we terminate the SPA or fail to renew the SPA, The Home Depot shall have the right and license to use the "Facelifters" mark for a 12 month period after such termination date under the same terms as stated above.

*Other Terms.* The SPA contains various representations, warranties and covenants as is customary in a commercial transaction of this nature. The SPA also provides for mutual agreements relating to confidentiality, indemnification, limitations of liability and arbitration.

## Environmental and Government Regulations

Generally, our activities and the activities of our sales representatives and contractors are subject to various federal and state laws and regulations and municipal ordinances relating to, among other things, in-home sales, consumer credit financing, advertising, the licensing of home improvement contractors, building permits, zoning regulations, environmental protection, safety and health. For example, The Home Depot purchasers of our products in an in-home setting are often afforded under Federal Trade Commission rules and various state consumer protection statutes relating to door-to-door sales, a "cooling off" period of three or more business days in which to rescind their transaction. We are also subject to various state and federal laws related to telemarketing, including the National Do Not Call Registry which is part of the Federal Trade Commission Telemarketing Sales Rule and the Federal Communication's Telephone Consumer Protection Act. We have procedures designed to comply with such laws and regulations. We do not anticipate any difficulty in complying with applicable federal, state or local laws and regulations relating to our home improvement business operations.

## Employees

At December 31, 2008 we had approximately 823 employees, including 11 employees engaged in marketing activities, 370 sales representatives, 190 manufacturing and installation employees, and 252 management and administrative personnel.

## Risks Factors

The risks and uncertainties described below could materially and adversely affect our business, financial condition and results of operations and could cause actual results to differ materially from our expectations and projections. While we believe that our assumptions, expectations and projections are reasonable in view of the currently available information, you are cautioned not to place undue reliance on our "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance. They are subject to future events, risks and uncertainties—many of which are beyond our control—as well as potentially inaccurate assumptions that could cause actual results to differ materially from our expectations and projections. Forward-looking statements may relate to such matters as our ability to obtain new customers under our agreement with The Home Depot, anticipated size or trends of the markets in which we compete and the anticipated competition in these markets, sales and revenue growth, state of the residential housing and credit markets, commodity price inflation, the effect of adopting certain accounting standards, and the demand for our products and services. You should read these Risk Factors in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operation" in this report and our Consolidated Financial Statements and related notes in this report. There also may be other factors that we cannot anticipate or that are not described in this report, generally because we do not perceive them to be material, that could cause results to differ materially from our expectations. Forward-looking statements speak only as of the date they are made, and we do not undertake to update these forward-looking statements. You are advised, however, to review any further disclosures we make on related subjects in our periodic filings with the SEC.

***As a result of the current economic recession, customer demand for home improvement products and the availability of financing have significantly declined which adversely affects our business.***

Our business relies on consumer demand for our home improvement products and services and the availability of financing for home improvement projects. The current declining economic environment, low levels of consumer confidence and the downward pressure on home prices have adversely affected demand for home improvement products, such as kitchen and bath remodeling projects. Further, recent disruptions in credit markets, characterized by the bankruptcy and failure of several financial institutions and severe limitations on credit availability, have limited the ability of consumers to finance home improvements. Approximately 85% of our The Home Depot customers elect to utilize financing products provided principally through The Home Depot to fund their home improvement project. In the second half of 2008, we experienced a significant increase in the number of customers who were declined financing for their home improvement project, which adversely impacted our new sales orders.

Although we believe the long-term outlook for the home improvement industry and our business is favorable, we cannot provide any assurances that current market conditions will not deteriorate further and we cannot predict the timing or strength of a recovery in the home improvement industry. Continued depressed activity levels in consumer spending for home improvement projects will continue to adversely affect our results of operations and our financial position. Furthermore, continued economic turmoil may cause unanticipated shifts in consumer preferences and purchasing practices and in the business model and strategies of The Home Depot, our strategic partner. Such shifts may alter the nature and prices of home improvement products demanded by The Home Depot and its customers and could adversely affect our operating performance.

***Termination of our service provider agreement with The Home Depot would significantly reduce our revenues, net income and available liquidity.***

Since October 2003 our home improvement operations have engaged in an aggressive expansion program under our agreements with The Home Depot. In May 2006 we entered into a three year service provider agreement with The Home Depot, which has been extended to February 2011. During the term of this agreement we have agreed not to enter into any agreement or other arrangements with The Home Depot competitors relating to the marketing, selling or providing of our products and installation services. We believe our relationship with The Home Depot is a significant factor to the achievement of our business strategy and long-term growth. Our primary business strategy is to expand our product distribution and grow our home improvement business through our relationship with The Home Depot. As of December 31, 2008, all of our home improvement operations exclusively served The Home Depot customers in designated markets.

Our current agreement with The Home Depot may be terminated by us or The Home Depot with 180 days written notice to the other party. Additionally, the agreement may also be terminated by either party with 30 days written notice upon a breach by either party of any obligations under the agreement, if such breach is not remedied within 30 days. If our The Home Depot agreement is terminated prior to the end of its term or is not renewed at the end of its term, whether as a result of our failure to fulfill our obligations under the agreement or The Home Depot's decision to change its business strategy, we would be required to seek alternative channels of distribution for our products and installation services. Additionally, our net income and liquidity may be reduced if revenues from other programs were less than those anticipated under our agreement with The Home Depot, and such revenues may not be sufficient to cover expenses incurred in connection with new programs. If our The Home Depot agreement is cancelled or not renewed at the end of its term our investment in sales and installation centers may be impaired, which may require a write-down of assets, including goodwill.

***Lower than anticipated revenues or higher than anticipated operating costs associated with our agreement with The Home Depot or our failure to obtain a significant number of customer leads could reduce our net income and available liquidity and limit our ability to further expand our relationship with The Home Depot.***

Lower than anticipated revenues or higher than anticipated expenses associated with our agreement with The Home Depot could reduce our net income and liquidity. Lower than anticipated revenues from our agreement with The Home Depot could result from an inadequate supply of prospective customer leads or reduced demand for our products. The Home Depot is not contractually required to promote or advertise our products. If we are unable to secure a sufficient quantity of prospective customers, or if sales are less than anticipated due to reduced demand for our products and services, our revenues, net income and liquidity could be adversely effected. Additionally, unanticipated delays in implementing the roll-out into new markets due to factors that may include difficulties in attracting and training an adequate work force could result in less than anticipated sales levels.

Higher than anticipated expenses in the markets which we serve or from a roll-out into new The Home Depot markets could result from various factors, including increased or higher than anticipated labor costs, material costs, real estate costs for new sales and installation centers, or higher than anticipated expenses for machinery, equipment, furniture and fixtures, product displays or inventory. If we are unable to maintain adequate liquidity, we may not be able to completely meet our obligations of any future roll-out programs or take advantage of other future opportunities The Home Depot may present to us.

***Negative publicity about The Home Depot or its home improvement products and services or the home improvement industry in general could negatively impact our revenues and earnings.***

Our home improvement operations exclusively serve The Home Depot customers in designated markets. Our kitchen and bath refacing home improvement products are marketed under "The Home Depot Kitchen and Bathroom Refacing" brand. Since our business is very dependent on the commercial success and public image of The Home Depot and its home improvement products and services, adverse or negative publicity about The Home Depot could in turn negatively impact our revenues and net income.

***Difficulties in meeting our installation staffing needs could impair our ability to complete projects on time, which could in turn negatively impact our revenues and impair our relationship with The Home Depot and its customers.***

To fulfill our growth expectations, we must engage and retain a sufficient number of qualified independent contractor and employee installers. Historically, during periods of strong economic growth and low unemployment, we experience greater difficulty in meeting our installation labor resource needs. Our inability to engage and retain qualified installers may impede our ability to timely complete our home improvement projects which could reduce our revenues and impair our relationship with The Home Depot and its customers.

***Rising costs, a reduction in the availability of financing, weather and other conditions in the United States could adversely affect our costs of doing business, demand for our products and services and negatively impact our revenues and net income.***

Interest rates, fuel and other energy costs, labor costs, availability of financing, state of the residential housing and credit markets, consumer confidence and general economic outlook, weather, natural disasters, terrorism and other conditions that adversely affect consumer demand for our products and services could adversely affect our financial performance. These and other similar factors could result in a decline in customer leads and sales which would negatively impact our revenues and net income.

***We may be unable to efficiently integrate acquisitions into our business, which could result in less than anticipated revenues or net income from such acquisitions.***

Our primary business strategy is to expand our product distribution and grow our home improvement business through our relationship with The Home Depot. In pursuit of our strategy, we may consider strategic acquisitions or partnerships that will complement or expand our sales, marketing, installation or manufacturing synergies as well as additional products which we may be able to offer The Home Depot customers. Acquisitions involve risks including lower than anticipated earnings and cash flows, unforeseen liabilities relating to or arising out of the acquisition, quality problems related to the acquired assets, adverse personnel relations and other risks affecting the acquired entity. The process of integrating acquired entities into our business will require management time and our financial resources. We may experience disruptions and incur unexpected expenses in integrating acquisitions. Future acquisitions could also result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities in the form of earn-outs or other contingent compensation, or other items, any of which could adversely affect our business. Any such acquisitions may not enhance our business, results of operations, cash flows or financial condition. Difficulties in integrating acquisitions may result in less than anticipated revenues and net income from such acquisitions.

***If additional capital is not available to us, we may not be able to take advantage of additional growth opportunities.***

We may have additional opportunities to grow our relationship with The Home Depot, which may require us to seek additional capital to fund these new business opportunities. We may be unable to obtain additional capital or, if available, we may not be able to obtain such capital on favorable terms. If capital is not available to us, we may not be able to expand our relationship with The Home Depot or be able to take advantage of additional growth opportunities, including acquisitions.

***If we raise additional capital it could diminish the rights of existing stockholders and may reduce our net income.***

If we need additional capital, we may have to issue additional equity or debt securities. If we issue equity securities, the ownership percentage of our stockholders will be reduced. If we borrow money, we may incur significant interest charges which could reduce our net income. Holders of debt or preferred securities may have rights, preferences or privileges senior to those of existing holders of our common stock.

***Failure to retain experienced senior management could impair our business operations.***

The success of our current business strategy depends to a significant extent on the continued services and experience of our executive officers and senior management team. Although we have entered into employment agreements with all of our executive officers, those agreements do not ensure their continued employment with us. If for any reason our executive officers or senior management do not continue to be active in management, our business could be disrupted, and we may experience a reduction in revenue or net income.

***We and The Home Depot may experience greater competition from large home center retailers which could result in decreased demand for our products and services, pricing pressure and reduced gross margins.***

We and The Home Depot compete with large home center retailers in each of the markets in which we and The Home Depot operate, including Sears and Lowe's. Many of these retailers currently offer competing products and services and may look to expand their ability to provide remodeling services directly to their customers. As we continue our expansion program with The Home Depot, we anticipate that we and The Home Depot will face greater competition from these home center retailers. Increased competition could result in pricing pressures, fewer customer orders, reduced gross margins, loss of market share and decreased demand for our products and services.

***Our failure to comply with laws and regulations could significantly disrupt our business, increase our legal expenses and reduce our net income.***

Our business activities and the activities of our sales representatives and contractors are subject to various federal and state laws and regulations and municipal ordinances relating to, among other things, in-home sales, the licensing of home improvement contractors, permitting and zoning regulations. For example, purchasers of our products in an in-home setting are often afforded under Federal Trade Commission rules and various state consumer protection statutes relating to door-to-door sales, a "cooling off" period of three or more business days in which to rescind their transaction. Violations of any of these or other laws and regulations could result in suspension or revocation of our license to do business in a state, monetary fines, public relations problems or increased regulatory scrutiny and cause us to incur significant legal and other expenses, which could reduce our net income.

***We are subject to pending class action litigation which could be costly.***

We are a defendant in several pending class action, as yet uncertified, lawsuits predicated upon claims for wage and hour violations and unfair business acts and practices. We have denied liability and intend to vigorously defend these cases. However, even when there is no basis for imposing liability such lawsuits are particularly costly to defend and resolve due to their scope, complexity and the potentially significant exposure that is alleged. See "Legal Proceedings" included in this Annual Report on Form 10-K for additional information about litigation involving our business.

***Seasonal factors can reduce our revenues and net income.***

Our home improvement business is subject to seasonal trends. The generation of sales orders for our kitchen and bath products typically declines in the last six weeks of the year during the holiday season. The seasonal variations generally negatively impact first quarter revenues and net income. Extreme weather conditions in the markets we serve sometimes negatively impact our revenues and net income.

***Our common stock price may be subject to wide fluctuations, which could result in losses for our stockholders.***

Our common stock price could be subject to wide fluctuations in response to a number of factors and these fluctuations could result in losses for our stockholders. Factors that could cause our stock price to fluctuate include:

- relatively low trading volume;
- quarterly variations in operating results;
- availability of financing for The Home Depot and our customers;
- announcements by our competitors concerning new products, significant contracts, acquisitions or strategic relationships;
- negative publicity about us, our products and services, our strategic partner, or the home improvement industry in general;
- departures of key management personnel;

- increases in interest rates or stock market price and volume fluctuations of publicly-traded companies in general and home improvement companies in particular; and
- the other factors described in these "Risk Factors."

The stock market in general, and securities listed on the Nasdaq Stock Market in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to operating performance. These broad market and industry fluctuations may materially reduce the market price of our common stock, regardless of our operating performance.

## PROPERTIES

As of December 31, 2008 we operated 44 home improvement sales and installation centers and we maintain a marketing center in Boca Raton, Florida. We manufacture certain of our kitchen cabinet refacing products and bathroom cabinetry at our Charles City, Virginia facility. Since we have ceased offering our deck products, we are actively marketing for sale our Woodbridge, Virginia manufacturing facility. We maintain our corporate office in Lewisville, Texas.

We lease all our properties, except for the Woodbridge and Charles City, Virginia facilities, which we own. All of our leases are for terms of five years or less.

## LEGAL PROCEEDINGS

We are subject to various legal proceedings and claims that arise in the ordinary course of business. We do not believe the amount of ultimate liability with respect to these actions will materially affect our financial position or results of operations.

In July 2007 a class action, as yet uncertified, was filed against the Company in Superior Court of the State of California for the County of Los Angeles Central District, alleging certain violations of the California Labor Code and unfair business acts and practices in violation of the California Business and Profession Code. The case was subsequently removed to the U.S. District Court for the Central District of California—Western Division. This action was filed by two former employees ("Plaintiffs"). The Plaintiffs assert the claims on their behalf and a class of all others similarly situated. Relief sought in the complaint includes unspecified damages, injunctive and equitable relief, punitive damages, penalties (in addition to wages owed) and attorney fees. The Company filed a Motion to Dismiss which was denied by the Court. The Company believes the claims by Plaintiffs are without merit and intends to vigorously defend this action. At this time, the Company cannot predict the outcome of this action or determine the amount of any potential damages.

In June 2007, a class action, as yet uncertified, was filed by a home improvement customer of the The Home Depot against The Home Depot, Inc., Expo Designs Center, et al. ("Defendants") in the Superior Court of the State of California for the County of Los Angeles, alleging certain unfair business acts and practices, violations of the California Consumer Legal Remedies Act and breach of contract. The case was subsequently removed to the U.S. District Court for the Central District of California. The Federal District Court granted Defendants' Motion to Dismiss the Original Complaint. Plaintiffs, who are comprised of two home improvement customers of the Company and The Home Depot, filed their First Amended Complaint in October 2007, which included the Company as a defendant. Plaintiffs subsequently filed their Second Amended Complaint against Defendants on December 21, 2007, which contained basically the same allegations as the Original and First Amended Complaints. Plaintiffs assert the claims on their behalf and a class of all others similarly situated. Relief sought in the Second Amended Complaint includes unspecified damages, and other equitable relief and attorney fees. On April 9, 2008, the U.S. District Court granted Defendants' Motion to Dismiss Plaintiffs' Second Amended

Complaint and ordered Plaintiffs' Complaint dismissed with prejudice. Plaintiffs have appealed this ruling to the United States Court of Appeals for the Ninth Circuit. The Company believes the claims by Plaintiffs are without merit and intends to vigorously defend this matter. At this time the Company cannot predict the outcome of this action or determine the amount of any potential damages.

In February 2009 a class action, as yet uncertified, was filed against the Company in the Superior Court of California for the County of Alameda, alleging certain violations of the California Labor Code, California Industrial Welfare Commission Wage Order 16-2001 and California Business and Professions Code. This action was filed by a former employee ("Plaintiff"). The Plaintiff asserts the claims on his behalf and a class of all others similarly situated. Relief sought in the complaint includes unspecified damages, injunctive and equitable relief, punitive damages, penalties (in addition to wages owed) and attorney fees. The Company believes the claims by Plaintiff are without merit and intends to vigorously defend this action. At this time, the Company cannot predict the outcome of this action or determine the amount of any potential damages.

In February 2009 a class/collective action was filed against the Company in the United States District Court for the District of New Jersey, alleging certain violations of Fair Labor Standards Act and the New Jersey Wage and Hour Law. This action was filed by an employee of the Company ("Plaintiff"). The Plaintiff asserts claims on his behalf and as a collective action on behalf of all individuals who were employed by the Company as installers in the United States, with the exception of California, since February 24, 2006 and as a class action, as yet uncertified, on behalf of all individuals who were employed by the Company as installers in the State of New Jersey since February 24, 2007. Relief sought in the complaint includes injunctive and equitable relief, overtime wages, liquidated damages and penalties and attorneys fees. The Company believes the claims by Plaintiff are without merit and intends to vigorously defend this action. At this time, the Company cannot predict the outcome of this action or determine the amount of any potential damages.

## SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of our stockholders during the fourth quarter of the fiscal year covered by this report.

[ REST OF PAGE INTENTIONALLY LEFT BLANK ]

## PART II

## MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

### Common Stock Prices

The following table sets forth, for the quarters indicated, the range of closing high and low sales prices of our common stock as reported by the Nasdaq Global Market and its predecessor, Nasdaq National Market.

| By Quarter Ended | Common Stock High | Common Stock Low |
|---|---|---|
| **Fiscal 2007** | | |
| March 31, 2007 | $13.16 | $10.96 |
| June 30, 2007 | $16.00 | $ 9.55 |
| September 30, 2007 | $10.47 | $ 6.39 |
| December 31, 2007 | $ 7.36 | $ 4.63 |
| **Fiscal 2008** | | |
| March 31, 2008 | $ 5.67 | $ 2.98 |
| June 30, 2008 | $ 4.95 | $ 3.31 |
| September 30, 2008 | $ 4.06 | $ 3.29 |
| December 31, 2008 | $ 3.40 | $ 1.67 |

As of March 10, 2009, there were 7,370,374 shares of our common stock outstanding held by approximately 193 stockholders of record.

We have never declared or paid any cash dividends on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future. We currently intend to retain future earnings, if any, to finance operations and the expansion of our business.

The Transfer Agent for our common stock is Corporate Stock Transfer, Denver, Colorado.

### Unregistered Sales of Equity Securities and Use of Proceeds

During the fourth quarter, we repurchased 143,926 shares of our common stock at a cost of $335,251. The number and average price of shares purchased in each fiscal month of the fourth quarter of fiscal 2008 are set forth in the table below:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share (1) | Total Number of Shares Purchased as part of Publicly Announced Program (1) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program (1) |
|---|---|---|---|---|
| October 1, 2008—October 31, 2008 | 18,113 | $3.42 | 186,440 | $1,298,768 |
| November 1, 2008—November 30, 2008 | 44,989 | $1.93 | 231,429 | $1,211,875 |
| December 1, 2008—December 31, 2008 | 80,824 | $2.31 | 312,253 | $1,025,533 |

(1) The Company's current common stock repurchase program was announced on March 18, 2008. The Board of Directors authorized the repurchase of up to $2.0 million of the Company's common stock. Any repurchase of common stock under the Company's stock repurchase program may be made in the open market at such time and such prices as the Company's CEO may from time to time determine. The program does not have an expiration date. Cumulative repurchases under this program through December 31, 2008 were 312,253 shares at a cost of approximately $974,000.

## Equity Compensation Plans

The following table provides information as of December 31, 2008 with respect to our common shares issuable under equity compensation plans:

| Plan Category | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a)) |
|---|---|---|---|
| Equity compensation plans approved by security holders: | | | |
| 2000 Stock Compensation Plan(1) (2) (3) | 366,213 | $3.87 | 581,382 |
| 2004 Restricted Stock Plan(4) | 18,602 | $ — | 366,495 |
| Equity compensation plans not approved by security holders | — | — | — |
| Total | 384,815 | $3.87 | 947,877 |

(1) Our 2000 Stock Compensation Plan allows for the granting of share options to employees, directors and advisors.

(2) Excludes 5,625 outstanding share options assumed in connection with the merger of U.S. Remodelers with us in 2001 at a weighted average exercise price of $8.40. We do not intend to issue any additional options under the assumed plans.

(3) The maximum number of shares of common stock in respect to which options may be granted under the 2000 Stock Compensation Plan, or the 2000 Plan, is 3,000,000 shares without limitation, and the number of shares in respect of which options may be granted to any one person is 300,000 shares during any single calendar year. Our board of directors approved restricting the number of shares available for options under the 2000 Plan to 20% of the outstanding shares of common stock of the Company. The board retained the authority to increase the number of shares available for options under the 2000 Plan up to a maximum of 3,000,000 shares from time to time as may be necessary in the future to provide ample shares for options under the 2000 Plan for our employees, directors and advisors.

(4) Pursuant to this plan, our employees and directors may be granted restricted stock awards under such terms as determined by our Compensation Committee. The Compensation Committee is authorized to grant up to a maximum of 500,000 restricted stock awards for our common stock under this Plan.

[ REST OF PAGE INTENTIONALLY LEFT BLANK ]

## SELECTED FINANCIAL DATA

The following table provides selected historical consolidated financial data for the periods ended and as of the dates indicated. The selected historical consolidated statement of operations data and consolidated balance sheet data presented below for the five most recent fiscal years ended December 31, 2008, have been derived from our audited consolidated financial statements. The historical results are not necessarily indicative of the results to be expected in any future period. You should read the selected consolidated financial data presented below in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with our consolidated financial statements and the related notes.

| | As of and for the year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (In thousands, except share and per share data) | | | | |
| **Summary of Operations Data:** | | | | | |
| Total revenues | $ 132,503 | $ 123,275 | $ 120,811 | $ 98,122 | $ 82,901 |
| Cost of remodeling contracts | 62,864 | 58,803 | 56,983 | 49,931 | 43,915 |
| Gross profit | 69,639 | 64,472 | 63,828 | 48,191 | 38,986 |
| Costs and expenses: | | | | | |
| Branch operations | 9,031 | 8,022 | 7,392 | 5,300 | 3,118 |
| Sales, marketing and license fees | 48,541 | 42,692 | 40,638 | 33,270 | 28,978 |
| General and administrative | 10,652 | 9,903 | 8,888 | 8,210 | 8,078 |
| Restructuring charge | — | — | — | 1,321 | — |
| Income (loss) from operations | 1,415 | 3,855 | 6,910 | 90 | (1,188) |
| Other income (expenses)[1] | (21) | 257 | (84) | (77) | (101) |
| Income tax expense (benefit) | 619 | 1,701 | 2,729 | 3 | (418) |
| Income (loss) from continuing operations | 775 | 2,411 | 4,097 | 10 | (871) |
| Income (loss) from discontinued operations, net of tax | — | (2,710) | 122 | (415) | 271 |
| Net income (loss) | $ 775 | $ (299) | $ 4,219 | $ (405) | $ (600) |
| Net income (loss) per common share—basic: | | | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.50 | $ 0.00 | $ (0.12) |
| Discontinued operations | $ — | $ (0.33) | $ 0.02 | $ (0.05) | $ 0.04 |
| Net income (loss) | $ 0.10 | $ (0.04) | $ 0.52 | $ (0.05) | $ (0.08) |
| Net income (loss) per common share—diluted: | | | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.49 | $ 0.00 | $ (0.12) |
| Discontinued operations | $ — | $ (0.33) | $ 0.02 | $ (0.05) | $ 0.04 |
| Net income (loss) | $ 0.10 | $ (0.04) | $ 0.51 | $ (0.05) | $ (0.08) |
| Number of weighted-average shares of common stock outstanding | | | | | |
| Basic | 7,558,840 | 8,160,702 | 8,114,598 | 7,936,715 | 7,230,021 |
| Diluted | 7,582,871 | 8,277,402 | 8,295,233 | 8,059,563 | 7,230,021 |
| **Balance Sheet Data:** | | | | | |
| Cash and cash equivalents | $ 9,826 | $ 11,616 | $ 10,562 | $ 4,417 | $ 3,442 |
| Marketable Securities | 2,036 | — | — | — | — |
| Total assets | 31,889 | 35,307 | 38,801 | 74,358 | 71,643 |
| Long-term debt and capital leases | 2,745 | 2,861 | 3,080 | 45,435 | 42,537 |
| Stockholders' equity | $ 22,820 | $ 22,759 | $ 26,887 | $ 21,049 | $ 21,181 |

(1) Includes interest expense, interest income, and other non-operating items.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following should be read in conjunction with our audited financial statements for the years ended December 31, 2008, 2007 and 2006, and the notes to these financial statements included therein. Except for the historical information contained herein, certain matters set forth in this report are forward-looking statements that are based on management's current expectations, estimates and projections about our business and operations. Our actual results may differ materially from those currently anticipated and as expressed in such forward-looking statements as a result of a number of factors, including those described under the caption "Business—Risk Factors" and elsewhere in this report.

### Overview

We are engaged in the specialty product home improvement business. In our home improvement business, we manufacture or procure, design, sell and install custom kitchen and bathroom cabinet refacing products and organizational storage systems for closets and garages. We market, sell and install our products and installed services exclusively through The Home Depot under a service provider agreement (SPA).

During the period of June 2007 through August 2007 we opened new kitchen refacing sales and installation centers in Nashville, Tennessee, Birmingham, Alabama, Harrisburg, Pennsylvania and Rochester, New York. In March 2007 we launched a pilot program with The Home Depot for the introduction of countertop products in the Boston market. This product offering consists of laminate and solid-surface countertops, including Corian, Silestone and granite. We have completed the roll out of countertop products in all markets where we offer our kitchen refacing products.

In the quarter ended June 30, 2008, we completed the opening of kitchen refacing sales and installation centers in Columbus, Cincinnati and Cleveland, Ohio, and Pittsburgh, Pennsylvania markets, encompassing approximately 96 The Home Depot stores.

In February 2008 we and The Home Depot mutually agreed to terminate the installed deck program under the SPA. As a result, effective February 29, 2008, we ceased receiving customer leads from The Home Depot for our deck products in the Midwest, Boston, Connecticut, Virginia Beach and Atlanta markets, and on October 15, 2008 we ceased receiving customer leads in our remaining deck markets, including Northern Virginia, Maryland, Philadelphia, New Jersey and New York. At December 31, 2008 we had completed the manufacture, but not installation, of all pending deck orders for The Home Depot customers in these markets. We expect to complete the installation of the remaining orders in the first quarter of 2009.

We had planned to return to marketing our deck products under our own Designer Deck brand in the Northern Virginia, Maryland, Philadelphia and New Jersey markets after the phase-out of our deck products in The Home Depot stores was completed. However, as a result of a number of factors, in November 2008 we decided to completely cease offering deck products. Among other items, the factors we considered in making our decision included our growth strategy to concentrate our resources on offering products that can be distributed across a wider geographic footprint of our strategic partner, The Home Depot, our expectation for continuing depressed demand for deck products as a result of the softness in the housing market, and the immediate challenge and expense of reintroducing our Designer Deck brand as we enter the seasonal downturn for deck sales.

In July 2008 we and The Home Depot began testing a pilot program in the Dallas market to offer a new range of home storage organization products for closets and the garage. We are currently working with The Home Depot to provide for a roll out of these products to be offered in markets where we currently offer our kitchen refacing products. We will begin this roll out in the first quarter of 2009 and complete the roll out in the third quarter of 2009. In connection with this product category we purchased a 33.33% membership interest in

Blue Viking Storage, LLC ("Blue Viking"), a distributor of garage organizer systems and accessories. In conjunction with the membership interest, we entered into a consulting agreement with Blue Viking in which Blue Viking will provide us sales and marketing consulting to support our entry and expansion into the garage and home storage industry.

In December 2008 we entered into a franchise agreement (the "Franchise Agreement") with Harris Research, Inc., a wholly owned subsidiary of The Home Depot. The five year Franchise Agreement allows us to market, sell and apply a wood kitchen cabinet and wood floor refinishing system through selected The Home Depot stores in the Boston, Massachusetts, Long Island, New York, and Philadelphia, Pennsylvania markets under the brand name N-Hance. The N-Hance wood renewal system utilizes a proprietary process involving the application of N-Hance cleaners, neutralizers, repair/fillers, coloring agents, sealers and finishes. In connection with the Franchise Agreement, the Company paid a franchise fee of approximately $80,000. The franchise fee is included in "Other assets" on the Consolidated Balance Sheet.

At December 31, 2008, our home improvement business served The Home Depot in 42 markets covering 27 states. Our kitchen products are available in all 42 markets encompassing approximately 1,660 The Home Depot stores and 33 The Home Depot—Expo stores. Our bath products are currently offered in 17 markets which include approximately 567 stores. In the first quarter 2009, The Home Depot announced that it was closing its Expos stores.

Effective September 30, 2007, we exited the consumer finance business when we and First Consumer Credit, Inc., or FCC, our consumer finance subsidiary, entered into an asset purchase agreement with FCC Finance, LLC, or FCC-Finance, whereby FCC sold substantially all of its assets to FCC-Finance for approximately $2.6 million in a buyout led by management of the consumer finance unit. As a result of the transaction, the financial operating results of FCC for all periods have been reclassified as discontinued operations in our Consolidated Statements of Operations.

Prior to the sale of FCC's assets, we had two reporting segments, the home improvement segment and consumer finance segment. As a result of the sale of FCC's assets and the reclassification of FCC's operating results as a discontinued operation, we have eliminated the previous separate segment reporting.

## Results of Operations

**Results of operations for the year ended December 31, 2008 as compared to the year ended December 31, 2007**

| | (In thousands) Year ended December 31, | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | $000 | % | $000 | % |
| Revenues | $132,503 | 100.0 | $123,275 | 100.0 |
| Costs of remodeling contracts | 62,864 | 47.4 | 58,803 | 47.7 |
| Gross Profit | 69,639 | 52.6 | 64,472 | 52.3 |
| Costs and expenses: | | | | |
| Branch operations | 9,031 | 6.8 | 8,022 | 6.6 |
| Sales, marketing and license fees | 48,541 | 36.6 | 42,692 | 34.6 |
| General and administrative | 10,652 | 8.1 | 9,903 | 8.0 |
| Operating income | 1,415 | 1.1 | 3,855 | 3.1 |
| Interest expense | 171 | 0.1 | 212 | 0.2 |
| Other income | 150 | 0.1 | 469 | 0.4 |
| Income from continuing operations before income taxes | 1,394 | 1.1 | 4,112 | 3.3 |
| Income tax expense | 619 | 0.5 | 1,701 | 1.3 |
| Net income from continuing operations | 775 | 0.6 | 2,411 | 2.0 |
| Net loss on discontinued operations, net of tax | — | — | (2,710) | (2.2) |
| Net income (loss) | $ 775 | 0.6 | $ (299) | (0.2) |

**Management's Summary of Results of Operations.**

Revenues for the year ended December 31, 2008 increased 7.5% to $132,503,000 as compared to $123,275,000 in the prior year period. Operating income was $1,415,000 in 2008 as compared with $3,855,000 in 2007. The decline in our operating profit reflected the following:

| Item | $000 Increase (decrease) to Operating Income |
|---|---|
| Increase in revenues | $ 2,791 |
| Increase in effective cost of marketing programs | (2,326) |
| Increase in 2008 operating costs for offices opened in 2008 and 2007 | (1,181) |
| Increase in sales commission rates | (600) |
| Increase in legal fees | (636) |
| Charges related to ceasing deck products | (514) |
| Other | 26 |
| Total decrease in operating income | $(2,440) |

Although we increased our revenues, we incurred higher operating expenses and one time charges resulting in a decline of our operating profit of $2,440,000. We believe the principal factors resulting in a decline of our operating income were:

- Our marketing costs increased from 21.2% of revenues in 2007 to 22.8% in 2008. In June 2007 we initiated a new in-store marketing program to generate prospective customer leads. In our in-store program we principally utilize an independent marketing firm to staff The Home Depot stores. Our marketing cost to acquire a customer through our in-store marketing program is higher than when the customer is referred to us directly from The Home Depot. The higher cost is a result of two factors: (i) we pay a fee to both our third party marketing firm and The Home Depot on each sale, and (ii) our sales closing efficiencies are lower under the third party provider program than our other lead generation sources thereby increasing the effective fee rate of the program.

Although acquiring a customer lead in the in-store program has been more costly, the in-store program has been effective at generating a greater quantity of customer leads than we have previously achieved without the program. During 2008 we have generated a substantial portion of our customer leads and revenues through our in-store marketing program.

Consequently, the increase in marketing expenditures as a percentage of revenues is principally due to a higher cost of the in-store marketing program and mix of our business generated from the in-store program.

In the fourth quarter of 2008 we initiated an employee based in-store marketing program in selected markets. We plan to expand our employee model into additional The Home Depot stores to supplement our third party provider and to establish a presence in a greater number of The Home Depot stores. We are continuing to evaluate the effectiveness of the in-store program as well as utilizing media and direct mail where we believe our expenditures will provide an appropriate return.

- Our fixed sales and branch operating costs increased approximately $801,000 in 2008 in markets we opened during 2008. In addition, our expenses increased $380,000 in markets we opened in 2007 as these markets were only open a portion of the prior year. Although these markets generated revenues in 2008, in the aggregate, we incurred an operating loss of $642,000 in these markets in 2008.
- In November 2007 management implemented certain changes to our sales compensation programs, including an increase in the commission rate we pay our sales associates on each sale. As a result of the commission rate increase, sales commissions increased $600,000 during 2008.
- We are subject to various legal proceedings and claims that arise in the ordinary course of business. In addition, we are vigorously defending ourselves against certain potential class action law suits (see "Legal Proceedings"). Although we believe the claims by the plaintiffs are without merit and we do not anticipate the amount of ultimate liability with respect to these actions will materially affect our financial position or results of operations, at this time, we cannot predict the outcome of these actions or determine the amount of any potential damages. Our legal fees as a result of these actions have increased $636,000 in 2008.
- In connection with our decision to cease offering deck products we recorded charges of $514,000 in 2008. These charges included $484,000 for inventory and equipment asset write-downs, and $30,000 for severance and other shutdown related expenditures.

Our new orders, excluding orders for deck products, increased $6,994,000 or 6.6%, to $113,128,000 in 2008 from $106,134,000 in 2007. New orders from markets open in 2008 were $3,090,000. Excluding new orders from new markets, management attributes the increase in new orders to an increase in the number of customer appointments generated from our in-store marketing program.

Despite the success of our in-store marketing program, we believe that economic pressures, including the softness in the housing market, uncertainty in the credit markets and rising unemployment have had an adverse effect on our generation of new orders. As these conditions worsened throughout 2008, our new orders (excluding deck products) in the second half of 2008 declined 11% from the first half of 2008, and fell approximately 4% from the second half of 2007. A key contributor to the decline was a reduction in the number of customers approved for financing. Approximately 85% of our customers elect to utilize financing products provided principally through The Home Depot to fund their home improvement project. Customers must qualify under these programs to receive financing. In the second half of 2008 we experienced a sharp increase in the number of customers who were declined financing for their home improvement project, thereby adversely impacting our new orders.

Our net income from continuing operations was $775,000, or $0.10 per diluted share, for 2008 as compared to $2,411,000, or $0.29 per share, in 2007. Consolidated net income was the same as net income from continuing operations in 2008 as compared to a net loss of $299,000, or $0.04 per share, for 2007.

*Outlook:* Our business relies on consumer demand for home improvement products and services and the availability of financing for home improvement projects. Although we believe the long-term outlook for the home improvement industry and our business is favorable, we expect similar weakness in the current economic environment to prevail in the first half of 2009. We cannot predict if current market conditions will deteriorate further or the timing or strength of a recovery in the home improvement industry. We believe that continuing economic pressures, along with a significantly lower backlog of orders at December 31, 2008, and continued higher costs to acquire customers, will negatively affect our operating results for the first half of 2009. Management expects the Company to incur an operating loss in the first quarter of 2009. Management will continue to address the operating environment to focus on its marketing strategy, and as necessary, make cost adjustments to support its long term objectives.

**Results of Operations—Detail Review**

Revenues for the year ended December 31, 2008 increased 7.5% to $132,503,000 as compared to $123,275,000 in the prior year period. Approximately 70% of the increase, or $6,498,000, was realized in markets that were opened prior to 2008. The remaining 30% of the increase, or $2,730,000, resulted from new sales and installation centers we opened in Ohio and Pennsylvania.

| | (In thousands) | | |
|---|---|---|---|
| | Year ended December 31, | | Increase |
| | 2008 | 2007 | $ |
| Markets opened prior to 2008 | $129,773 | $123,275 | $6,498 |
| Markets opened in 2008 | 2,730 | — | 2,730 |
| Total Home Improvement revenues | $132,503 | $123,275 | $9,228 |

Revenues and new orders for the years ended December 31, 2008 and 2007, and backlog of uncompleted orders at December 31, 2008 and 2007 attributable to each of our product lines were as follows (in thousands):

| | Revenues | | New Orders | | Backlog | |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Kitchen refacing and Countertops | $110,543 | $ 92,634 | $104,417 | $ 95,883 | $12,245 | $18,371 |
| Bathroom refacing | 8,981 | 10,298 | 8,370 | 10,220 | 763 | 1,374 |
| Decks | 12,665 | 20,343 | 8,784 | 22,066 | 359 | 4,240 |
| Organizers | 314 | — | 341 | 31 | 58 | 31 |
| Total Home Improvement | $132,503 | $123,275 | $121,912 | $128,200 | $13,425 | $24,016 |

*Kitchen refacing and countertops* – New orders for kitchen and countertop products increased $8,534,000 or 8.9%, to $104,417,000 in 2008 from $95,883,000 in 2007. New orders from markets opened in 2008 were $3,090,000. Excluding new orders from new markets, management attributes the increase in new orders to an increase in the number of customer appointments generated from our in-store marketing program which we initiated in late June 2007.

As economic conditions worsened throughout 2008, our new orders for kitchen and countertop products in the second half of 2008 declined 11% from the first half of 2008 and fell 2.5% from the second half of 2007. A key contributor to the decline was a reduction in the number of customers approved for financing.

Revenues from kitchen refacing and countertop products increased $17,909,000 or 19.3%, to $110,543,000 in 2008 from $92,634,000 in 2007. The increase in revenues principally reflects higher new orders in the current period and reduced installation cycle time. We generally complete the installation of a new order in approximately 60 days from the date of the order. However, in the first half of 2008 we increased our production and installation capacity resulting in reduced cycle time and increased revenues in the second half of 2008.

*Bathroom refacing* – New orders for bath products declined $1,850,000 or 18.1%, to $8,370,000 in 2008 from $10,220,000 in 2007. Management attributes the decline in bath product new orders to the Company's promotional emphasis on its kitchen products. Management intends to increase its marketing efforts for bath products in 2009.

Revenues from bathroom refacing products were $8,981,000 in the year ended December 31, 2008 as compared with $10,298,000 in the prior year.

*Decks* – New orders for deck products were $8,784,000 in 2008 as compared with $22,066,000 in 2007 and revenues were $12,665,000 and $20,343,000, respectively. The decline in deck new orders and revenues reflects the phase out of our deck products in The Home Depot stores.

Gross profit for the year ended December 31, 2008 was $69,639,000, or 52.6% of revenues, as compared with $64,472,000, or 52.3% of revenues, in the prior year period. The increase in gross profit in dollar terms is principally due to the increase in revenues.

In connection with our decision to cease offering deck products we incurred charges of $395,000 for asset write downs which are included in "Cost of remodeling contracts" in our Consolidated Statements of Operations. These charges reduced gross profit by 30 basis points. Excluding the deck related charges, gross profit as a percentage of revenue increased 60 basis points due to favorable product mix (14 basis points), improved kitchen and bath refacing product margins from price increases and production efficiencies (16 basis points), and the leveraging effect of our fixed production costs over higher revenues (30 basis points).

Branch operating expenses were $9,031,000 as compared to $8,022,000 for the years ended December 31, 2008 and 2007, respectively. Branch operating expenses are primarily comprised of fixed costs associated with each of our sales and installation centers, including rent, telecommunications, branch administration salaries and supplies. Branch operating expenses increased $421,000 as a result of the expansion of our operations in new markets opened in 2008. Branch operating expenses in 2008 increased $380,000 in markets which we opened in 2007 as a result of having a full year of operating costs. The remaining increase of $208,000 is principally due to increased wages.

Marketing expenses were $30,239,000, or 22.8% of revenues in the year ended December 31, 2008 as compared with $26,185,000, or 21.2% of revenues last year. Marketing expenses consist primarily of marketing fees we pay to The Home Depot on each sale, commissions on each sale associated with our in-store marketing program, advertising, and personnel and facility costs related to maintaining our marketing center.

In June 2007 we initiated a new in-store marketing program. Concurrent with the initiation of the in-store program we reduced our advertising expenditures on media and direct mail as these mediums' response rates have failed to meet our requirements. We believe the in-store program is more effective than these mediums and therefore during 2008 we continued to expand this program into additional The Home Depot stores. In our in-store program we principally utilize an independent marketing firm to staff The Home Depot stores. We pay a commission fee on each customer lead generated under the program that results in a new sales order. The commission fee is expensed to marketing expense when the related contract revenues are recognized. If certain performance criteria are met, a bonus is payable to the marketing firm, and if the criteria are not met, a refund is due us which reduces the effective rate of the program. In the fourth quarter 2008, we initiated our own employee-based program in selected The Home Depot stores. We plan to expand our employee model into additional select stores to supplement our third party provider and to establish a presence in a greater number of The Home Depot stores.

Our marketing cost to acquire a customer through our in-store marketing program is higher than when the customer is referred to us directly from The Home Depot. The higher cost is a result of the combined fees we pay to our third party marketing firm, or similar costs to employ our employee in-store model, and The Home Depot fee on each sale. However, the in-store program has been effective at generating a greater quantity of customer leads than we have previously achieved without the program.

Consequently, the increase in marketing expenditures as a percentage of revenues is principally due to an increase in the mix of our business which is generated from our in-store program at a higher effective cost. We are continuing to evaluate the effectiveness of the in-store program as well as utilizing media and direct mail where we believe our expenditures will provide an appropriate return.

Sales expenses, which consist primarily of sales commissions and bonuses, sales manager salaries, travel and recruiting expenses were $18,302,000, or 13.8% of revenues for the year ended December 31, 2008, as compared to $16,507,000, or 13.4% of revenues in the prior year period. Sales expense increases included $948,000 for sales commissions and related payroll taxes resulting from higher revenues, $600,000 in higher sales commissions from an increase in the sales commission rate we pay our sales representatives, $273,000 for expansion of our operations in new markets opened in 2008, and a $90,000 asset impairment charge related to in-store deck displays.

General and administrative expenses were $10,652,000, or 8.1% of revenues for the year ended December 31, 2008, as compared to $9,903,000, or 8.0% of revenues in the prior year period. The increase in general and administrative expense was principally the result of an increase of $137,000 in personnel costs, including salaries, benefits, bonuses and payroll taxes, $298,000 in recruiting expenses primarily related to sales personnel, and $636,000 in legal fees offset by a worker's compensation insurance refund of $117,000.

Our effective income tax rate from continuing operations in 2008 reflects changes in the mix and amount of permanent tax differences and state taxes as compared to last year. Our effective income tax rate increased in 2008 to 44.4% of pretax income as compared to 41.4% last year.

**Discontinued Operations**

Effective September 30, 2007, we exited the consumer finance business when our finance subsidiary, First Consumer Credit, Inc., or FCC, entered into an asset purchase agreement with FCC Finance, LLC, or FCC-Finance, whereby FCC sold substantially all of its assets to FCC-Finance for approximately $2.6 million in a buyout led by management of the consumer finance subsidiary. Included among the assets sold were FCC's portfolio of retail installment contracts, or RIOs, FCC's servicing asset, furniture, fixtures, equipment, goodwill and certain intellectual property. Assets retained included cash and certain accounts receivable. As a result of the transaction, the financial operating results of FCC for all periods have been reclassified as discontinued operations in our Consolidated statement of operations.

In connection with the transaction, FCC recognized a pre-tax loss of $1,370,000, which included a write down of goodwill related to the finance business unit. Because the goodwill associated with the finance business did not qualify as a tax deduction under tax regulations, the transaction resulted in a taxable gain for which we recognized an income tax expense on the transaction of approximately $910,000. The resulting net loss from the transaction was $2,280,000. Excluding the loss from the transaction, FCC incurred a net loss of $430,000 in the year ended December 31, 2007.

**Liquidity and Capital Resources**

We have historically financed our liquidity needs through cash flows from operations, borrowing under bank credit agreements and proceeds from the sale of common stock. At December 31, 2008, we had approximately $9,826,000 in cash and cash equivalents and $2,036,000 in marketable securities. Working capital at December 31, 2008 was $16,375,000.

Cash generated from operations was $2,512,000 in the year ended December 31, 2008. Net cash provided by operations in the year ended December 31, 2007 was $1,547,000. We utilized $863,000 for capital expenditures in 2008, principally consisting of machinery, equipment, computer hardware and software and furniture and fixtures. We also purchased shares in a tax free municipal bond fund in the amount of $2,040,000. In 2008 we purchased a 33.33% membership interest in Blue Viking Storage, LLC ("Blue Viking"), a distributor of garage organizational systems and accessories, for $195,000. We believe garage organizational systems are a growing home improvement product category that will fit well into our product portfolio and distribution channel.

On March 13, 2008, the Board of Directors also authorized an additional repurchase of the Company's outstanding stock up to $2 million. Any repurchase under the Company's stock repurchase program may be made in the open market at such times and such prices as the Company may determine appropriate. Cumulative repurchases under this authorization through December 31, 2008 were 312,253 shares at a cost of approximately $974,000.

Effective September 30, 2007, we sold substantially all of the assets of our consumer finance business, FCC, to FCC-Finance for approximately $2,652,000 in a buyout led by management of the consumer finance unit. Concurrent with the sale of FCC's assets, FCC terminated its rights under the Participation Agreement. The Participation Agreement provided FCC with a preferred rate of return on its non-owner participation interest investment in a RIO portfolio owned by the Trust. Upon termination of the participation Agreement, FCC received a return of its remaining investment principal balance of $1,577,000.

The proceeds from the sale, as well as the return of the principal balance of FCC's participation investment (an aggregate of $4,229,000), are included in Investing Activities in our Consolidated Statement of Cash Flows.

In the year ended December 31, 2007, net cash utilized in investing and financing activities was approximately $494,000. Investing and financing activities principally include the cash generated from the FCC transaction, capital expenditures, proceeds from the issuance of common stock and borrowings and repayments of debt obligations. In 2007, financing activities also included the utilization of approximately $4,985,000 to repurchase shares of the Company's common stock.

At December 31, 2008, principal and interest payments due under our contractual obligations were as follows:

| | Payments Due (In Thousands) | | | | |
|---|---|---|---|---|---|
| | **Total** | **Less than 1 year** | **1-3 years** | **3-5 years** | **More than 5 years** |
| Long term debt | $ 2,745 | $ 214 | $1,359 | $ 352 | $820 |
| Operating leases | 8,182 | 3,011 | 4,176 | 995 | — |
| | $10,927 | $3,225 | $5,535 | $1,347 | $820 |

The principal balance of long term debt and lines of credit consisted of the following at December 31, 2008 and 2007.

| | December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Frost Term loan | $1,133,330 | $1,200,000 |
| Mortgage payable in monthly principal and interest payments of $19,398 through January 1, 2018 | 1,545,556 | 1,661,673 |
| Other | 66,004 | — |
| | $2,744,890 | $2,861,673 |

Our term loan is related to our kitchen manufacturing facility in Charles City, Virginia. Interest only on the term note was paid monthly at the London Interbank Offered Rate, or LIBOR, plus 2.0% (3.18% at December 31, 2008 and 6.83% at December 31, 2007) until February 10, 2008. Thereafter, a monthly principal payment of $6,667 is payable plus accrued interest until February 10, 2011, at which time any outstanding principal and accrued interest is due and payable.

We also have a mortgage on our Woodbridge, Virginia deck warehousing, manufacturing and office facilities. The mortgage is secured by this property. Interest on the mortgage is 7.25% and the mortgage is subject to a prepayment premium. The mortgage is payable in monthly principal and interest payments of $19,398 through January 1, 2018.

We have a line of credit under our loan agreement with Frost National Bank (the "Borrowing Base Line of Credit"). On December 18, 2008 we renewed and amended our loan agreement and the Borrowing Base Line of Credit. The Borrowing Base Line of Credit, as amended, allows borrowings up to $4 million for working capital. Borrowings and required payments under the Borrowing Base Line of Credit are based upon an asset formula involving accounts receivable and inventory. At December 31, 2008 we had no balance outstanding under the Borrowing Base Line of Credit, and had a borrowing capacity of approximately $3,104,000. The Borrowing Base Line matures May 2, 2010, at which time any outstanding principal and accrued interest is due and payable.

Our credit facilities contain covenants, which among other matters, (i) limit our ability to incur indebtedness, merge, consolidate and sell assets; (ii) require us to satisfy certain ratios related to tangible net worth and fixed charge coverage; and (iii) limit us from making any acquisition which requires in any fiscal year $1.0 million cash or $2.0 million of cash and non-cash consideration. We are in compliance with all restrictive covenants at December 31, 2008.

In connection with our agreement with The Home Depot we will open sales and installation centers as we enter new markets. Opening these facilities requires expenditures for facility improvements, machinery, furniture and fixtures, inventory, product displays, sales kits and requires cash to fund operating losses during the initial months following the opening of a facility. In addition, our initiatives in 2009 with The Home Depot will include the introduction of additional products in markets we serve. Introducing additional products requires expenditures customarily associated with rolling out products in new territories.

We believe that current economic pressures will persist in the first half of 2009. In addition, we expect that the effective costs to acquire customers in 2009 will remain higher than our historic levels. In the aggregate we expect these factors will negatively affect our operating results for the first half of 2009. However, we believe we will be successful in executing our initiatives and that we will have sufficient cash, including cash generated by operations, and borrowing capacity under our credit facilities to meet our anticipated working capital needs for our current operations over the next twelve months and that such capacity will be adequate to fund the expansion of our operations under our agreement with The Home Depot for the next 12-18 months. However, if we need additional capital to execute our business strategy or fund our operations, we may have to issue equity or debt securities. If we issue additional equity securities, the ownership percentage of our stockholders will be reduced. If we borrow money, we may incur significant interest charges which could reduce our net income. Holders of debt or preferred securities may have rights, preferences or privileges senior to those of existing holders of our common stock. However, additional financing may not be available to us, or if available, such financing may not be on favorable terms.

### Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses during the reporting period.

Actual results could differ from those estimates. Note 2 to the Consolidated Financial Statements included elsewhere herein includes a summary of the significant accounting policies and methods used by us in the preparation of our financial statements. We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements.

**Warranty**

Our products are covered by specific warranties. For our kitchen, bathroom, countertop and organization systems products, in addition to the manufacturer's warranty for defective materials, we provide each customer a one-year limited warranty covering workmanship and, a limited warranty covering defective materials. For our deck products, we provide a one-year warranty covering defective workmanship, a three-year warranty on structure and a limited three-year warranty against rot, decay and termites. Although we have ceased offering our deck products, we will continue to honor our warranty service obligations to The Home Depot customers who purchased our deck products.

The estimated costs of warranty obligations are accrued at the time we complete the installation of an order based on various factors, including the Company's stated warranty policies and practices, the historical frequency of claims and the cost to replace or repair its products under warranty. Historically our warranty obligations have occurred in the first 90 days following completion of an order and generally relate to defective materials. We require each of our independent contractors to correct defective workmanship for a 12-month period at no cost to us.

Each quarter we re-evaluate our estimate of accrued warranty obligations. If our warranty experience were to deteriorate, or if our independent subcontractors were not available to correct defective workmanship, our warranty costs could increase and additional reserves may be required. For example, at December 31, 2008, based on historical experience, we estimated our warranty obligation cost per claim at 0.7% of the sales order amount. If, given our same estimated claim experience, our warranty cost per claim were to increase 10%, we would be required to increase our accrued warranty obligation at December 31, 2008 by approximately $30,000.

**Goodwill**

The Company is required to test goodwill for impairment at least on an annual basis or more often if an event or circumstance indicates that an impairment, or decline in value may have occurred. Due to the current economic environment, the Company's stock price and market capitalization declined in the past quarter. As a result, the Company concluded that indicators have emerged that required impairment testing to be performed as of December 31, 2008.

Accordingly, the Company completed tests for impairment of goodwill at December 31, 2008. For purposes of assessing impairment under SFAS No. 142, the Company is a single reporting unit. We determined the fair value of our reporting unit at December 31, 2008 based on a weighting of market and income approaches. Under the income approach, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. The Company places greater emphasis on the income approach because it provides a fair value estimate based upon the reporting unit's expected long-term operating cash flow performance. The market approach includes consideration of recent trends in our market capitalization and an expected control premium, based on comparable transaction history. Based upon the results of this testing, the Company concluded that no impairment of goodwill existed at December 31, 2008.

If we were to determine that impairment existed, we would be required to record a charge to expense to write goodwill down to its fair value. If, for example, due to a decline in revenues resulting from the termination of our program with The Home Depot, the present value of discounted cash flows were to decline by 32% from our current projections, we would be required to write down our goodwill.

### Stock Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123R. Under the provisions of SFAS No. 123R, stock based compensation is estimated at the grant date based on the award's fair value as calculated by the Black Scholes (BS Model)option pricing model and is recognized as expense over the requisite service period. The BS Model requires various highly judgmental assumptions including volatility and expected option life. In addition, we are required to estimate the expected forfeiture rate of options and awards and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience. If any of these assumptions change significantly, stock based compensation expense is adjusted accordingly.

### Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "*Fair Value Measurements*" ("SFAS No. 157"), which establishes a framework for measuring fair value under other accounting pronouncements that require fair value measurements and expands disclosures about such measurements. SFAS No. 157 does not require any new fair value measurements, but rather it creates a consistent method for calculating fair value measurements to address non-comparability of financial statements containing fair value measurements utilizing different definitions of fair value. We adopted SFAS No. 157 effective January 1, 2008. The adoption of SFAS No. 157 had no impact on the Company's consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115"* ("SFAS No.159"), which allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the Company elects for similar types of assets and liabilities. We adopted SFAS No. 159 effective January 1, 2008. The adoption of SFAS No. 159 had no impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 141, (revised 2007), "*Business Combinations*" ("SFAS No. 141(R)"), which continues the evolution toward fair value reporting and significantly changes the accounting for acquisitions that close beginning in 2009, both at the acquisition date and in subsequent periods. SFAS No. 141(R) introduces new accounting concepts and valuation complexities and many of the changes have the potential to generate greater earnings volatility after the acquisition. SFAS 141(R) also requires that acquisition costs be expensed as incurred and restructuring costs be expensed in periods after the acquisition date. SFAS No. 141(R) will only affect the Company's financial condition or results of operations to the extent it has business combinations after the effective date.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 160, *"Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51"* ("SFAS No. 160"), which requires companies to measure an acquisition of noncontrolling (minority) interest at fair value in the equity section of the acquiring entity's balance sheet. The objective of SFAS No. 160 is to improve the comparability and transparency of financial data as well as to help prevent manipulation of earnings. The changes introduced by the new standards are likely to affect the planning and execution as well as the accounting and disclosure of merger transactions. The Company will adopt SFAS No. 160 on January 1, 2009. The adoption of SFAS No. 160 is not expected to have a material effect on the Company's results of operations or financial position.

In February 2008, FASB issued FASB Staff Position ("FSP") FAS 157-2, *"Effective Date of FASB Statement No. 157*", which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed in the financial statements on a nonrecurring basis. The FSP partially defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for items within the scope of this FSP. The adoption of SFAS 157, as applied to financial assets and financial liabilities, did not have a material effect on the Company's financial position or results of operations. The Company has not applied the provisions of SFAS 157 to its nonfinancial assets and nonfinancial liabilities in accordance with FSP FAS 157-2. The Company will apply the provisions of SFAS 157 to these assets and liabilities beginning January 1, 2009. The adoption of this second phase of SFAS 157 in January 2009 will not have a material effect on the Company's results of operations or financial position.

In April 2008 the FASB issued FASB Staff Position ("FSP") No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors to be considered in developing renewal or extension assumptions used to determine the useful life of intangible assets under SFAS No. 142. Its intent is to improve the consistency between the useful life of an intangible asset and the period of expected cash flows used to measure its fair value. This FSP was effective for the Company on January 1, 2009. The adoption of FSP 142-3 will not have a material effect on the Company's consolidated financial statements.

In November 2008, the FASB ratified a consensus opinion reached by the Emerging Issues Task Force (EITF) on EITF Issue 08-6, *"Equity Method Investment Accounting Considerations,"* to clarify accounting and impairment considerations involving equity method investments after the effective date of both FASB Statement 141 (revised 2007), *Business Combinations*, and FASB Statement 160, *Noncontrolling Interests in Consolidated Financial Statements*. EITF Issue 08-6 includes the Task Force's conclusions on how an equity method investor should (1) initially measure its equity method investment, (2) account for impairment charges recorded by its investee, and (3) account for shares issued by the investee. The Company adopted EITF Issue 08-6 effective January 1, 2009. EITF Issue 08-6 will only affect the Company's financial condition or results of operations if the Company makes any future investments accounted for under the equity method.

**Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or variable interest entities, or VIEs, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of December 31, 2008, we are not involved in VIE or off-balance sheet transactions.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to financial market risks from changes in short-term interest rates since our credit facilities and debt agreements contain interest rates that vary with interest rate changes in LIBOR. However, based on our current aggregate variable debt level, we believe that these rates would have to increase significantly for the resulting adverse impact on our interest expense to be material to our results of operations.

## FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Reference is made to page F-1 herein for the Index to Financial Statements. The information required in Schedule II—Valuation and Qualifying Accounts is included in the Notes to the Financial Statements.

## CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

**Not applicable**

## CONTROLS AND PROCEDURES

**Evaluation of Disclosure Controls and Procedures.**

Disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and include controls and procedures designed to ensure that information we are required to disclose in such reports is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our management, under the supervision and with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 3a-15(f) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. We believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

**Management's Annual Report on Internal Control over Financial Reporting.**

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Exchange Act.

Internal control over financial reporting is defined under the Exchange Act as a process designed by, or under the supervision of, our CEO and CFO and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitation, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluations of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate. Accordingly, even an effective system of internal control over financial reporting will provide only reasonable assurance with respect to financial statement preparation.

Our management, with the participation of our CEO and CFO, evaluated the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control—Integrated Framework. Based on this evaluation and those criteria, our management, with the participation of our CEO and CFO, concluded that, as of December 31, 2008, our internal control over financial reporting was effective.

This Annual Report does not include an attestation report of our registered public accounting firm regarding our internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's report in this Annual Report.

**Changes in Internal Control over Financial Reporting.**

There have not been any changes in our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f)) that occurred during the fourth fiscal quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

# PART III

## DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is incorporated herein by reference to our proxy statement for the 2009 annual meeting of stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934, as amended (the "Proxy Statement").

## EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the Proxy Statement.

## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the Proxy Statement.

## CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the Proxy Statement.

## PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this item is incorporated herein by reference to the Proxy Statement.

## PART IV

## EXHIBITS, FINANCIAL STATEMENT SCHEDULES,

(a)(1)(2) Financial Statements and Schedules. Reference is made to page F-1 herein for the Index to Financial Statements.

(a)(3) and (c) Exhibits:

| Exhibit Number | Description of Exhibit |
|---|---|
| 2.1(a) | Agreement and Plan of Merger between U.S. Pawn, Inc. and U.S. Remodelers, Inc. dated as of November 3, 2000 |
| 2.2(b) | Agreement and Plan of Merger dated February 13, 2001, by and between U.S. Pawn, Inc. and U.S. Home Systems, Inc. |
| 2.3(c) | Agreement and Plan of Merger dated September 28, 2001, by and between Home Credit Acquisition, Inc., U.S. Home Systems, Inc., and First Consumer Credit, LLC and its members |
| 2.4(d) | Agreement and Plan of Merger by and among Remodelers Credit Corporation, a wholly-owned subsidiary of U.S. Home Systems, Inc., Deck America, Inc., and Shareholders of Deck America, Inc. dated October 16, 2002, and effective as of November 30, 2002 |
| 2.5(d) | Amendment No. 1 to Agreement and Plan of Merger entered into on November 30, 2002, by and among Remodelers Credit Corporation, U.S. Home Systems, Inc., Deck America, Inc., and Shareholders of Deck America, Inc. |
| 3.1(b) | Certificate of Incorporation of U.S. Home Systems, Inc. as filed with the Secretary of State of Delaware on January 5, 2001 |
| 3.2(b) | Bylaws of U.S. Home Systems, Inc. |
| 3.3(bb) | Amended Article VI to the U.S. Home Systems Bylaws. |
| 4.1(b) | Common Stock specimen—U.S. Home Systems, Inc. |
| 10.1(d) | Purchase and Sale Contract (Improved Property) executed and effective as of October 16, 2002, by and between Remodelers Credit Corporation and MAD, L.L.C. for improved property situated in Prince William County, City of Woodbridge, Virginia |
| 10.2(d) | Cognovit Promissory Note, dated December 4, 2002, in the principal amount of $2,125,000, executed in favor of General Electric Capital Business Asset Funding Corporation, as Payee, by Remodelers Credit Corporation, as Borrower |
| 10.3(d) | Guaranty Agreement, dated December 4, 2002, executed in favor of General Electric Capital Business Asset Funding Corporation, as Lender, by U.S. Home Systems, Inc., as Guarantor |
| 10.4(d) | Deed of Trust, Security Agreement, Assignment of Leases and Rents, Financing Statement and Fixture Filing, dated as of December 4, 2002, in favor of Lawyers Title Realty Services, Inc., as Trustee, for the benefit of General Electric Capital Business Asset Funding Corporation, as Beneficiary, by Remodelers Credit Corporation, as Trustor |
| 10.5(d) | Environmental Indemnity Agreement Regarding Hazardous Substances executed on December 4, 2002, by Remodelers Credit Corporation, as Borrower, and U.S. Home Systems, Inc., as Guarantor, for the benefit of General Electric Capital Business Asset Funding Corporation, as Lender |
| +10.6(e) | Employment Agreement by and between the U.S. Home Systems, Inc. and Murray H. Gross |
| +10.7(e) | Employment Agreement by and between the U.S. Home Systems, Inc. and Peter T. Bulger |

| Exhibit Number | Description of Exhibit |
|---|---|
| +10.8(e) | Employment Agreement by and between the U.S. Home Systems, Inc. and Steven L. Gross |
| +10.9(e) | Employment Agreement by and between the U.S. Home Systems, Inc. and Robert A. DeFronzo |
| +10.10(e) | Employment Agreement by and between the U.S. Home Systems, Inc. and Richard B. Goodner |
| +10.11(f) | Amended and Restated 2000 Stock Compensation Plan |
| +10.12(g) | Executive Cash Bonus Program adopted by Board of Directors of U.S. Home Systems, Inc. on February 5, 2004 |
| +10.13(h) | U.S. Home Systems, Inc. 2004 Restricted Stock Plan approved by the stockholders on July 15, 2004. |
| +10.14(i) | Non-Employee Director Compensation Plan |
| +10.15(i) | Form of Restricted Stock Agreement for Non-Employee Directors |
| +10.16(i) | Form of Restricted Stock Agreement for Employees |
| 10.17(j) | First Amended and Restated Loan Agreement, effective as of February 10, 2006, by and between U.S. Home Systems, Inc. ("U.S. Home") and The Frost National Bank ("Frost Bank"). |
| 10.18(j) | Revolving Promissory Note, effective as of February 10, 2006, in the principal amount of $4 million payable to the Frost Bank by U.S. Home. |
| 10.19(j) | Revolving Promissory Note, effective as of February 10, 2006, in the principal amount of $3 million payable to the Frost Bank by U.S. Home. |
| 10.20(j) | Term Note, effective as of February 10, 2006, in the principal amount of $1.2 million payable to the Frost Bank by U.S. Home. |
| 10.21(j) | Term Note, effective as of February 10, 2006, in the principal amount of $875,000 payable to the Frost Bank by U.S. Home. |
| 10.22(j) | First Amended and Restated Security Agreement executed by U.S. Home, and effective as of February 10, 2006, pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.23(j) | First Amended and Restated Security Agreement executed by First Consumer Credit, Inc. ("FCC"), a wholly owned subsidiary of U.S. Home, and effective as of February 10, 2006, pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.24(j) | First Amended and Restated Security Agreement executed by U.S. Remodelers, Inc. ("USR"), a wholly owned subsidiary of U.S. Home, and effective as of February 10, 2006, pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.25(j) | Deed of Trust, Security Agreement—Assignment of Rents, effective as of February 10, 2006, in favor of Michael K. Smeltzer, as trustee, for the benefit of Frost Bank, as beneficiary, executed by U.S. Remodelers, as grantor, pledging the real property and improvements located in Charles City, Virginia (as described in the Deed of Trust) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.26(j) | First Amended and Restated Guaranty Agreement executed by FCC, and effective as of February 10, 2006, to secure payment of indebtedness payable to Frost Bank by U.S. Home. |
| 10.27(j) | First Amended and Restated Guaranty Agreement executed by USR, and effective as of February 10, 2006, to secure payment of indebtedness payable to Frost Bank by U.S. Home. |

| Exhibit Number | Description of Exhibit |
|---|---|
| 10.28(j) | Arbitration and Notice of Final Agreement effective as of February 10, 2006 by and among Frost Bank, U.S. Home, FCC and USR. |
| 10.29(k) | Service Provider Agreement between USR and The Home Depot effective May 1, 2006 (certain exhibits and schedules have been omitted and will be furnished to the SEC upon request). |
| +10.30(l) | Amendment dated June 2, 2006 to Employment Agreement between U.S. Home Systems and Murray H. Gross. |
| 10.31(m) | Modification Agreement dated January 1, 2007, by and between U.S. Home and Frost Bank relating to $1.2 million Term Note. |
| 10.32(m) | Modification Agreement dated January 1, 2007, by and between U.S. Home and Frost Bank relating to $875,000 Term Loan. |
| 10.33(m) | First Amendment to First Amended and Restated Loan Agreement dated April 2, 2007 by and between U.S. Home and Frost Bank. |
| 10.34(m) | Revolving Promissory Note dated April 2, 2007, in the principal amount of $6 million payable to Frost Bank. |
| 10.35(m) | First Amendment to First Amended and Restated Security Agreement dated April 2, 2007 executed by U.S. Home, pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.36(m) | First Amendment to First Amended and Restated Security Agreement dated April 2, 2007 executed by U.S. Remodelers, Inc. pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.37(m) | First Amendment to First Amended and Restated Security Agreement dated April 2, 2007 executed by First Consumer Credit, Inc. pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home. |
| 10.38(m) | First Amendment to First Amended and Restated Guaranty Agreement executed by U.S. Remodelers, Inc. dated April 2, 2007 to secure payment of indebtedness payable to Frost Bank by U.S. Home. |
| 10.39(m) | First Amendment to First Amended and Restated Guaranty Agreement executed by First Consumer Credit dated April 2, 2007 to secure payment of indebtedness payable to Frost Bank by U.S. Home. |
| 10.40(m) | Arbitration and Notice of Final Agreements dated April 2, 2007 by and among Frost Bank, U.S. Home, U.S. Remodelers and First Consumer Credit. |
| 10.41(n) | Asset Purchase Agreement Among FCC Finance LLC, First Consumer Credit, Inc. and U.S. Home Systems, Inc. dated October 2, 2007. Certain schedules and exhibits have been omitted and will be furnished to the Commission upon request. |
| 10.42(n) | Transition Services Agreement by and among FCC Finance LLC, First Consumer Credit, Inc., U.S. Remodelers, Inc. and U.S. Home Systems, Inc. dated as of October 2, 2007. |
| 10.43(o) | Amendment dated February 28, 2008 to the Service Provider Agreement between USR and The Home Depot (Exhibit 10.29). |
| +10.44(p) | Amended and Restated Employment Agreement by and between U.S. Home Systems, Inc. and Murray H. Gross effective as of January 1, 2009. |
| +10.45(q) | Amended and Restated Employment Agreement by and between U.S. Home Systems, Inc. and Peter T. Bulger effective as of January 1, 2009. |

| Exhibit Number | Description of Exhibit |
|---|---|
| +10.46(q) | Amended and Restated Employment Agreement by and between U.S. Home Systems, Inc. and Robert A. DeFronzo effective as of January 1, 2009. |
| +10.47(q) | Amended and Restated Employment Agreement by and between U.S. Home Systems, Inc. and Steven L. Gross effective as of January 1, 2009 |
| +10.48(q) | Amended and Restated Employment Agreement by and between U.S. Home Systems, Inc. and Richard B. Goodner effective as of January 1, 2009 |
| 10.49(r) | Separation Agreement and General Release of Claims dated February 17, 2009 (effective as of February 24, 2009) by and among U.S. Home Systems, U.S. Remodelers and Peter T. Bulger |
| 10.50* | Second Amended and Restated Loan Agreement dated December 19, 2008 by and between U.S. Home Systems, Inc. and Frost Bank |
| 10.51* | Revolving Promissory Note dated December 19, 2008 in the principal amount of $4,000,000 payable to Frost Bank |
| 10.52* | Second Amended and Restated Security Agreement dated December 19, 2008 executed by U.S. Home Systems, pledging collateral (as described in the Security Agreement) as security for indebtedness owed Frost Bank by U.S. Home Systems, Inc. |
| 10.53* | Second Amended and Restated Security Agreement dated December 19, 2008 executed by U.S. Remodelers pledging collateral (as described in the Security Agreement) as security for indebtedness and Frost Bank by U.S. Home Systems, Inc. |
| 10.54* | Second Amended and Restated Guaranty Agreement executed by U.S. Remodelers dated December 19, 2008 to secure payment of indebtedness payable to Frost Bank by U.S. Home Systems, Inc. |
| 10.55* | Arbitration and Notice of Final Agreement dated December 19, 2008 by and among Frost Bank, U.S. Home Systems, Inc. and U.S. Remodelers, Inc. |
| 21.1(s) | Subsidiaries of the Company |
| 23.1* | Consent of Independent Registered Public Accounting Firm. |
| 31.1* | Chief Executive Officer Certification filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Chief Financial Officer Certification filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Chief Executive Officer Certification furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2* | Chief Financial Officer Certification furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Filed herewith.

\+ Management contract or compensatory plan or arrangement.

(a) Previously filed as Exhibit B to the Company's Proxy Statement which was filed with the Commission on December 15, 2000, and which is incorporated herein by reference.

(b) Previously filed as an exhibit to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000, which was filed with the Commission on April 2, 2001, and which is incorporated herein by reference.

(bb) Previously filed as an exhibit to the Company's Current Report on Form 8K which was filed with the Commission on December 21, 2007, and which is incorporated herein by reference.

(c) Previously filed as an exhibit to the Company's Current Report on Form 8-K/A which was filed with the Commission on November 27, 2001, and which is incorporated herein by reference.

(d) Previously filed as an exhibit to the Company's Current Report on Form 8-K/A which was filed with the Commission on February 5, 2003, and which is incorporated herein by reference.
(e) Previously filed as an exhibit to the Company's Amendment No. 1 to Registration Statement on Form S-1 which was filed with the Commission on March 15, 2004, and which is incorporated herein by reference.
(f) Previously filed as an exhibit to the Company's Registration Statement on Form S-8 which was filed with the Commission on July 19, 2002, and which is incorporated herein by reference.
(g) Previously filed as an exhibit to the Company' Annual Report on Form 10-K for the fiscal year ended December 31, 2003, which was filed with the Commission on April 6, 2004, and which is incorporated herein by reference.
(h) Previously filed as an exhibit to the Company's Current Report on Form 8-K which was filed with the Commission on July 21, 2004, and which is incorporated herein by reference.
(i) Previously filed as an exhibit to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, which was filed with the Commission on March 29, 2005, and which is incorporated herein by reference.
(j) Previously filed as an exhibit to the Company's Current Report on Form 8-K which was filed with the Commission on February 16, 2006, and which is incorporated herein by reference.
(k) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q which was filed with the Commission on August 10, 2006, and which is incorporated herein by reference.
(l) Previously filed as an exhibit to the Company's Current Report on Form 8-K which was filed with the Commission on June 8, 2006, and which is incorporated herein by reference.
(m) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q which was filed with the Commission on May 15, 2007, and which is incorporated herein by reference.
(n) Previously filed as an exhibit to the Company's current report on Form 8-K which was filed with the Commission on October 8, 2007, and which is incorporated herein by reference.
(o) Previously filed as an exhibit to the Company's Annual Report on Form 10-K which was filed with the Commission on March 18, 2008, and which is incorporated herein by reference.
(p) Previously filed as an exhibit to the Company's current report on Form 8-K which was filed with the Commission on December 16, 2008, and which is incorporated herein by reference.
(q) Previously filed as an exhibit to the Company's current report on Form 8-K which was filed with the Commission on January 5, 2009, and which is incorporated herein by reference.
(r) Previously filed as an exhibit to the Company's current report on Form 8-K/A which was filed with the Commission on February 23, 2009, and which is incorporated herein by reference.
(s) Previously filed as an exhibit to the Company's Annual Report on Form 10-K which was filed with the Commission on March 16, 2006, and which is incorporated herein by reference.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on March 16, 2009 on its behalf by the undersigned, thereto duly authorized.

**U.S. HOME SYSTEMS, INC.**

By: /s/ MURRAY H. GROSS
**Murray H. Gross, Chairman,**
**President and Chief Executive Officer**

By: /s/ ROBERT A. DEFRONZO
**Robert A. DeFronzo, Secretary-Treasurer,**
**Chief Financial Officer and Principal Accounting Officer**

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 16, 2009.

| Signature | Title | Date |
|---|---|---|
| /s/ MURRAY H. GROSS<br>**Murray H. Gross** | Chairman, President, Chief Executive Officer and Director | March 16, 2009 |
| /s/ ROBERT A. DEFRONZO<br>**Robert A. DeFronzo** | Secretary/Treasurer and Chief Financial Officer (Principal Accounting Officer) | March 16, 2009 |
| /s/ RICHARD GRINER<br>**Richard Griner** | Director | March 16, 2009 |
| /s/ DON A. BUCHHOLZ<br>**Don A. Buchholz** | Director | March 16, 2009 |
| /s/ LARRY A. JOBE<br>**Larry A. Jobe** | Director | March 16, 2009 |
| /s/ KENNETH W. MURPHY<br>**Kenneth W. Murphy** | Director | March 16, 2009 |

## U.S. HOME SYSTEMS, INC.

## INDEX TO FINANCIAL STATEMENTS

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
U.S. Home Systems, Inc.:

We have audited the accompanying consolidated balance sheets of U.S. Home Systems, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. 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 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of U.S. Home Systems, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Dallas, Texas
March 16, 2009

## U.S. Home Systems, Inc.

## Consolidated Balance Sheets

| | December 31 2008 | December 31 2007 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 9,825,528 | $11,615,593 |
| Marketable securities | 2,036,049 | — |
| Accounts receivable-trade, net | 3,060,337 | 3,792,553 |
| Accounts receivable-other | 28,060 | 99,027 |
| Income tax receivable | 574,303 | 1,059,143 |
| Commission advances | 863,405 | 1,324,855 |
| Inventories, net | 3,538,637 | 5,207,705 |
| Prepaid advertising and marketing | 1,272,535 | 1,166,296 |
| Prepaid expenses—other | 835,512 | 850,376 |
| Deferred income taxes | 568,737 | 645,404 |
| Total current assets | 22,603,103 | 25,760,952 |
| Property, plant, and equipment, net | 2,518,849 | 5,556,963 |
| Assets held for sale | 2,514,643 | — |
| Goodwill | 3,589,870 | 3,589,870 |
| Other assets | 662,391 | 399,359 |
| Total assets | $31,888,856 | $35,307,144 |
| **Liabilities and Stockholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 2,968,908 | $ 5,822,989 |
| Accrued wages, commissions, bonuses and vacation | 1,396,326 | 1,736,014 |
| Federal and state taxes payable | 616,182 | 748,519 |
| Long-term debt, current portion | 214,254 | 189,454 |
| Other accrued liabilities | 1,032,778 | 1,083,545 |
| Total current liabilities | 6,228,448 | 9,580,521 |
| Deferred income taxes | 309,942 | 295,450 |
| Long-term debt, net of current portion | 2,530,636 | 2,672,219 |
| Stockholders' equity: | | |
| Common stock—$0.001 par value, 30,000,000 shares authorized, 7,654,196 and 8,347,153 shares issued; 7,341,943 and 7,610,060 shares outstanding at December 31, 2008 and 2007, respectively | 7,654 | 8,347 |
| Additional capital | 15,449,223 | 20,173,056 |
| Retained earnings | 8,337,420 | 7,562,857 |
| Treasury stock, at cost, 312,253 and 737,093 shares at December 31, 2008 and 2007, respectively | (974,467) | (4,985,306) |
| Total stockholders' equity | 22,819,830 | 22,758,954 |
| Total liabilities and stockholders' equity | $31,888,856 | $35,307,144 |

See accompanying notes.

## U.S. Home Systems, Inc.

## Consolidated Statements of Operations

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Revenues from remodeling contracts | $132,502,981 | $123,275,204 | $120,811,246 |
| Costs of remodeling contracts | 62,864,359 | 58,803,121 | 56,983,100 |
| Gross profit | 69,638,622 | 64,472,083 | 63,828,146 |
| Costs and expenses: | | | |
| Branch operations | 9,030,777 | 8,021,988 | 7,392,220 |
| Sales and marketing expense | 48,540,797 | 42,692,179 | 40,638,036 |
| General and administrative | 10,652,137 | 9,902,863 | 8,888,058 |
| Income from operations | 1,414,911 | 3,855,053 | 6,909,832 |
| Interest expense | 170,823 | 212,485 | 415,927 |
| Other income, net | 149,911 | 469,630 | 332,049 |
| Income from continuing operations before income taxes | 1,393,999 | 4,112,198 | 6,825,954 |
| Income tax expense | 618,942 | 1,701,308 | 2,729,222 |
| Income from continuing operations | 775,057 | 2,410,890 | 4,096,732 |
| Discontinued operations: | | | |
| Income (loss) from discontinued operations before income taxes | (749) | (2,123,415) | 190,987 |
| Income tax expense (benefit) | (255) | 586,260 | 68,295 |
| Income (loss) from discontinued operations | (494) | (2,709,675) | 122,692 |
| Net income (loss) | $ 774,563 | $ (298,785) | $ 4,219,424 |
| Net income (loss) per common share: | | | |
| Basic: | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.50 |
| Discontinued operations | — | (0.33) | 0.02 |
| Net income (loss) | $ 0.10 | $ (0.04) | $ 0.52 |
| Diluted: | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.49 |
| Discontinued operations | — | (0.33) | 0.02 |
| Net income (loss) | $ 0.10 | $ (0.04) | $ 0.51 |
| Weighted average common shares outstanding: | | | |
| Basic | 7,558,840 | 8,160,702 | 8,114,598 |
| Diluted | 7,582,871 | 8,277,402 | 8,295,233 |

See accompanying notes.

# U.S. Home Systems, Inc.

## Consolidated Statements of Stockholders' Equity

| | Common Stock | | Common Stock Held in Treasury, at cost | | Additional | Unearned Compensation Restricted | Retained | Note Receivable For Stock | Total Stockholders' |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Capital | Stock Awards | Earnings | Issued | Equity |
| Balance at January 1, 2006 | 7,976,286 | $7,976 | — | — | $17,887,394 | $(213,224) | $3,642,218 | $(274,950) | $21,049,414 |
| Adoption of SFAS No. 123 | (45,542) | (45) | — | — | (213,179) | 213,224 | — | — | — |
| Issuance of common stock on stock option exercises and releases of restricted stock awards | 267,416 | 267 | — | — | 569,755 | — | — | — | 570,022 |
| Issuance of common stock in exchange for services | 12,000 | 12 | — | — | 92,388 | — | — | — | 92,400 |
| Tax benefits applicable to the exercise of employee stock options and awards | — | — | — | — | 263,679 | — | — | — | 263,679 |
| Payment of note receivable for stock issued | — | — | — | — | — | — | — | 274,950 | 274,950 |
| Stock compensation | — | — | — | — | 416,900 | — | — | — | 416,900 |
| Net income | — | — | — | — | — | — | 4,219,424 | — | 4,219,424 |
| Balance at December 31, 2006 | 8,210,160 | 8,210 | — | — | 19,016,937 | — | 7,861,642 | — | 26,886,789 |
| Issuance of common stock on stock option exercises and releases of restricted stock awards | 136,993 | 137 | — | — | 574,461 | — | — | — | 574,598 |
| Tax benefits applicable to the exercise of employee stock options and awards | — | — | — | — | 245,088 | — | — | — | 245,088 |
| Purchase of Treasury Stock | — | — | 737,093 | (4,985,306) | — | — | — | — | (4,985,306) |
| Stock compensation | — | — | — | — | 336,570 | — | — | — | 336,570 |
| Net loss | — | — | — | — | — | — | (298,785) | — | (298,785) |
| Balance at December 31, 2007 | 8,347,153 | 8,347 | 737,093 | (4,985,306) | 20,173,056 | — | 7,562,857 | — | 22,758,954 |
| Issuance of common stock on stock option exercises and releases of restricted stock awards | 44,136 | 44 | — | — | (44) | — | — | — | — |
| Tax benefits applicable to the exercise of employee stock options and awards | — | — | — | — | (32,397) | — | — | — | (32,397) |
| Purchase of Treasury Stock | — | — | 312,253 | (974,467) | — | — | — | — | (974,467) |
| Retirement of Treasury Stock | (737,093) | (737) | (737,093) | 4,985,306 | (4,984,569) | — | — | — | — |
| Stock compensation | — | — | — | — | 293,177 | — | — | — | 293,177 |
| Net income | — | — | — | — | — | — | 774,563 | — | 774,563 |
| Balance at December 31, 2008 | 7,654,196 | $7,654 | 312,253 | $ (974,467) | $15,449,223 | $ — | $8,337,420 | $ — | $22,819,830 |

See accompanying notes.

## U.S. Home Systems, Inc.

## Consolidated Statements of Cash Flows

| | Year Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Net income (loss) | $ 774,563 | $ (298,785) | $ 4,219,424 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,163,194 | 1,310,380 | 1,310,673 |
| Net provision for loan losses and bad debts | 68,881 | (12,119) | 816,580 |
| Gains from loan portfolio sales | — | — | (819,170) |
| Write-down of long-lived assets | 242,350 | — | — |
| Stock based compensation | 293,177 | 336,570 | 509,300 |
| Excess income tax benefit from stock option exercises and awards released | 32,397 | (245,088) | (263,679) |
| Loss on disposal of assets | 6,305 | 1,369,899 | — |
| Changes in operating assets and liabilities: | | | |
| Accounts and other receivables | 734,303 | 1,269,826 | (1,797,259) |
| Inventories | 1,669,068 | (948,839) | (951,919) |
| Commission advances and prepaid expenses | 370,075 | (1,583,225) | (275,294) |
| Accounts payable | (2,854,081) | 3,145,036 | (1,440,422) |
| Accrued expenses | (357,991) | (479,845) | 568,590 |
| Income taxes | 411,265 | (2,689,756) | 2,447,899 |
| Other assets and liabilities, net | (41,480) | 373,302 | 206,267 |
| Net cash provided by operating activities | 2,512,026 | 1,547,356 | 4,530,990 |
| **Cash flows from investing activities** | | | |
| Purchases of property, plant, and equipment | (863,127) | (1,061,837) | (1,046,994) |
| Proceeds from sale of assets | — | 2,656,172 | 18,069 |
| Proceeds from sale of RIOs | — | — | 51,715,449 |
| Purchase of finance receivables | — | — | (29,638,091) |
| Customer payments on finance receivables | — | 104,185 | 22,179,505 |
| Principal return of participation investment | — | 2,191,285 | (2,191,285) |
| Purchase of marketable securities | (2,040,062) | — | — |
| Purchase of equity method investment | (195,000) | — | — |
| Franchise fee | (14,251) | — | — |
| Net cash provided by (used in) investing activities | (3,112,440) | 3,889,805 | 41,036,653 |
| **Cash flows from financing activities** | | | |
| Proceeds from lines of credit and long-term borrowings | — | — | 12,545,867 |
| Principal payments on lines of credit, long-term debt | (182,787) | (217,920) | (54,901,582) |
| Change in restricted cash | — | — | 1,824,012 |
| Payments received on notes receivable | — | — | 274,950 |
| Excess income tax benefit (expense) from stock option exercises and awards released | (32,397) | 245,088 | 263,679 |
| Purchase of treasury stock | (974,467) | (4,985,306) | — |
| Issuance of common stock | — | 574,598 | 570,022 |
| Net cash used in financing activities | (1,189,651) | (4,383,540) | (39,423,052) |
| Net increase (decrease) in cash and cash equivalents | (1,790,065) | 1,053,621 | 6,144,591 |
| Cash and cash equivalents at beginning of year | 11,615,593 | 10,561,972 | 4,417,381 |
| Cash and cash equivalents at end of year | $ 9,825,528 | $11,615,593 | $ 10,561,972 |
| **Supplemental disclosure of cash flow information** | | | |
| Interest paid | $ 177,867 | $ 216,444 | $ 2,995,377 |
| Cash payments of income taxes, net of refunds | $ 109,058 | $ 5,163,362 | $ 505,242 |

See accompanying notes.

**U.S. Home Systems, Inc.**

**Notes to Consolidated Financial Statements**

**December 31, 2008**

## 1. Organization and Basis of Presentation

U.S. Home Systems, Inc. (the "Company" or "U.S. Home") is engaged in the specialty product home improvement business. The Company manufactures or procures, designs, sells and installs custom quality specialty home improvement products. The Company's principal product lines include kitchen and bathroom cabinet refacing products and related accessories.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions are eliminated in consolidation.

## 2. Summary of Significant Accounting Policies

The Company's accounting policies require it to apply methodologies, estimates and judgments that have significant impact on the results reported in the Company's financial statements. The following summarizes the Company's more 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 at the date of the financial statements, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses during the reporting period. The significant estimates that the Company makes include the allowance for doubtful accounts, reserves for excess and obsolete inventories, reserves for warranty claims, valuation of goodwill, and taxes, including sales and use taxes and state income taxes. Actual results could differ from those estimates.

***Fair Value***

In September 2006 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, *"Fair Value Measurements"* ("SFAS No. 157") which establishes a framework for measuring fair value under other accounting pronouncements that require fair value measurements and expands disclosures about such measurements. SFAS No. 157 defines fair value to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The Company adopted SFAS No. 157 effective January 1, 2008. The adoption of SFAS No. 157 had no impact on the Company's consolidated financial position, results of operations or cash flows. See Note 4 for more information, including a listing of our assets and liabilities required to be measured at fair value on a recurring basis and where they are classified within the SFAS No. 157 hierarchy as of December 31, 2008.

In February 2007 the FASB issued SFAS No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115"* ("SFAS No. 159"). SFAS No. 159 permits entities to choose, at specified election dates, to measure at fair value eligible financial assets and liabilities that are not otherwise measured at fair value, and report unrealized gains and losses for these items in current earnings at each subsequent reporting date (the "fair value option"). The Company adopted SFAS No. 159 effective January 1, 2008. The Company did not elect the fair value option. The adoption of SFAS No. 159 had no impact on the Company's consolidated financial position, results of operations or cash flows.

## 2. Summary of Significant Accounting Policies (Continued)

### *Fair Value of Financial Instruments*

The carrying amounts of the Company's financial instruments, including accounts receivable and accounts payable, approximate fair value due to their short-term nature. Based on prevailing interest rates at December 31, 2008, management believes that the carrying value of long-term debt approximates its fair value.

### *Cash and Cash Equivalents*

Cash and cash equivalents consist of cash in bank accounts and money market funds.

### *Investments*

The Company accounts for short-term marketable securities in accordance with SFAS No. 115, "*Accounting for Certain Investments in Debt and Equity Securities.*" At December 31, 2008, the Company's short-term investments consist of bond mutual funds which are classified as trading. Trading securities are recorded at fair value based on quoted market prices which is considered Level 1 in the SFAS 157 hierarchy. For the year ended December 31, 2008 the Company recognized $43,000 in interest earnings and an unrealized holding loss of approximately $4,000. These amounts are included in "Other income" in the Company's Consolidated Statements of Operations.

The equity method of accounting is used to account for investments in affiliated companies in which the Company does not exercise control and has a 20% or more voting interest. For the year ended December 31, 2008, the Company's share of losses from affiliated entities was approximately $10,000 and is included in the Company's consolidated operating results. The Company's initial investment of $195,000, reduced by its share of losses, is included in "Other assets" on the Company's Consolidated Balance Sheet at December 31, 2008.

### *Commission Advances*

Sales commissions are earned and finally calculable upon completion of installation of a sales order. Commission advances represent payments made against estimated sales commissions on sales orders received but not yet completed. The balance of any sales commission due is paid upon completion of the sales order. In the event a sales order is cancelled after the commission advance, or if the final calculated earned sales commission is less than the commission advance, such excess is recoverable from any and all subsequent final commission payments. The Company provides for estimated losses of uncollectible commission advances based upon specific identification of problem accounts and historical losses. Commission advances are reported net of estimated losses of $15,000 and $48,000 at December 31, 2008 and 2007, respectively.

### Concentrations of Credit Risk

Concentration risk represents the loss that would be recognized if counterparties failed to completely perform as contracted. Financial instruments that subject the Company to significant concentrations of credit risk consist of cash deposits in banks in excess of federally insured limits and accounts receivable from The Home Depot. We believe the risk of loss associated with our cash deposits to be remote.

At December 31, 2008, all of the Company's trade receivables are due from The Home Depot.

## 2. Summary of Significant Accounting Policies (Continued)

### *Accounts Receivable-trade*

Trade accounts receivable consist of amounts due from The Home Depot. Trade accounts receivable are reported net of allowance for doubtful accounts. The Company provides for estimated losses of uncollectible accounts based upon specific identification of problem accounts and expected default rates based on historical default rates. An allowance for losses is established through a provision for bad debts charged against income. The Company charges off accounts against the allowance when deemed to be uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The change in the allowance for bad debts is as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Balance at beginning of year | $131,378 | $ 246,205 | $253,201 |
| Provisions for doubtful accounts | 68,881 | (12,119) | 73,223 |
| Write-offs, net of recoveries | (59,101) | (102,708) | (80,219) |
| Balance at end of year | $141,158 | $ 131,378 | $246,205 |

### *Inventories*

Inventories (consisting of raw material and work-in-process) are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. Amounts in work-in process inventories relate to costs expended on firm orders and include material, labor and manufacturing overhead costs. The Company recognizes inventory reserves for unusable, slow-moving and obsolete items. As of December 31, 2008 and 2007, inventories are reflected net of reserves of $276,000 and $131,000, respectively.

### *Property, Plant, and Equipment*

Property, plant and equipment are carried at cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the estimated useful lives of the related assets, as follows:

| | |
|---|---|
| Buildings and improvements | 25 to 30 years |
| Machinery and equipment | 3 to 7 years |
| Furniture, fixtures and computer equipment | 3 to 7 years |

Leasehold improvements are amortized over the shorter of the term of the lease or the useful life of the related assets.

Costs associated with the repair and maintenance of the Company's property, plant and equipment are expensed as incurred. Costs associated with improvements which extend the life, increase the capacity or improve the efficiency of the Company's property, plant and equipment are capitalized and depreciated over the remaining life of the related asset.

### *Goodwill*

Goodwill relates to the Company's home improvement business. The amount of goodwill at December 31, 2008 and 2007 is $3,589,870.

## 2. Summary of Significant Accounting Policies (Continued)

Goodwill is not amortized to expense. However, the Company is required to test goodwill for impairment at least on an annual basis or more often if an event or circumstance indicates that an impairment, or decline in value may have occurred. Due to the current economic environment, the Company's stock price and market capitalization declined in the past quarter. As a result, the Company concluded that indicators have emerged that required impairment testing to be performed as of December 31, 2008.

Accordingly, the Company completed tests for impairment of goodwill at December 31, 2008. For purposes of assessing impairment under SFAS No. 142, the Company is a single reporting unit. We determined the fair value of our reporting unit at December 31, 2008 based on a weighting of market and income approaches. Under the income approach, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. The Company places greater emphasis on the income approach because it provides a fair value estimate based upon the reporting unit's expected long-term operating cash flow performance. The market approach includes consideration of recent trends in our market capitalization and an expected control premium, based on comparable transaction history. Based upon the results of this testing, the Company concluded that no impairment of goodwill existed at December 31, 2008.

### *Intangible Assets*

Intangible assets other than goodwill consist of license/franchise agreements which allow the Company to sell certain products in selected markets. The gross carrying value of intangible assets was $332,760 at December 31, 2008 and $ 252,505 at December 31, 2007, and accumulated amortization was $117,836 and $92,585, respectively. Intangible assets are amortized on a straight line basis, with estimated useful lives based on the terms of the license/franchise agreement. Amortization expense is estimated to be approximately $40,000 each year for the next five years. Intangible assets are included in "Other Assets" on the Company's Consolidated Balance Sheet.

### *Long-lived Assets*

Long-lived assets held and used by the Company (including other intangible assets) are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable. The Company evaluates recoverability of assets to be held and used by comparing the carrying amount of an asset to future net undiscounted cash flows to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets calculated using a discounted future cash flows analysis. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to dispose. Other intangible assets are amortized over the term of the related agreement.

### *Revenue Recognition*

Remodeling contract revenue is recognized in accordance with contract accounting utilizing the completed contract method. The completed contract method is used due to the short-term nature of our contracts. Revenue is recognized upon substantial completion and acceptance by the customer of each home improvement contract. Cost of remodeling contracts represents the costs of direct materials and labor associated with installation and manufacturing costs, including shipping and handling costs.

## 2. Summary of Significant Accounting Policies (Continued)

### *Advertising and Marketing*

The Company's advertising and marketing consists of a variety of media sources including direct mail, marriage mail, magazines, newspaper inserts and in-store displays at selected The Home Depot stores. The Company expenses all such costs as incurred.

In connection with the Company's in-store marketing program, the Company engages an unaffiliated service provider whose function is to generate prospective customer leads for the Company in designated The Home Depot stores. For each customer lead in which the Company enters into a sales order, the service provider receives a fee. The Company prepays the service provider fee upon entry into the sales order with the customer, however, the fee is not finally earned and calculable until completion of installation of the respective sales order. The Company records the advance payment in prepaid expense and recognizes the final expense in marketing expenses upon completion of installation of the sales order. If a sales order is cancelled after the advance payment, or if the final calculated earned fees are less than the advance payment, such excess is refundable by the service provider. Commission advances to the service provider of $1,273,000 and $1,166,000 are recorded as Prepaid advertising and marketing as of December 31, 2008 and 2007 respectively.

Marketing expense also includes marketing fees paid to The Home Depot on each sale.

Advertising and marketing expenses were approximately $30,239,000, $26,185,000 and $24,268,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

### *Income Taxes*

The Company accounts for income taxes under the liability method. Deferred income taxes are provided for temporary differences between the tax basis of assets and liabilities and their basis for financial reporting purposes. The provision for income tax expense or benefit differs from the amounts of income taxes currently payable because certain items of income and expense included in the consolidated financial statements are recognized in different time periods by taxing authorities.

On January 1, 2007, the Company adopted FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109, Accounting for Income Taxes"* ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes by establishing standards for measurement and recognition in financial statements of positions taken by an entity in its income tax returns and provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties, accounting for income taxes in interim periods and income tax disclosures. The Company had no adjustments as a result of its adoption of FIN 48.

The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. As of December 31, 2008, the Company had no unrecognized tax benefits, recognized no interest and penalties and had no interest and penalties accrued related to unrecognized tax benefits.

The Company, or one or more of its subsidiaries, files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal tax or state and local income tax examinations by tax authorities for tax years prior to 2005.

## 2. Summary of Significant Accounting Policies (Continued)

### *Warranties*

In addition to the manufacturers' warranties for defective materials, the Company provides each customer a limited warranty covering defective materials and workmanship. The estimated costs related to warranties are accrued at the time products are sold based on various factors, including the Company's stated warranty policies and practices, the historical frequency of claims and the cost to replace or repair its products under warranty. Warranty expenses are included in the cost of remodeling contracts. The following table provides a reconciliation of the activity related to the Company's accrued warranty expense.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Balance at beginning of year | $ 274,770 | $ 282,780 | $ 246,629 |
| Provision for warranty expenses | 1,002,526 | 1,378,207 | 1,048,286 |
| Warranty costs incurred | (978,929) | (1,386,217) | (1,012,135) |
| Balance at end of year | $ 298,367 | $ 274,770 | $ 282,780 |

### *Earnings Per Share*

Basic net income (loss) per share is computed by dividing the net income (loss) available to common stockholders for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share includes the effect of dilutive common stock equivalents except when those equivalents would be anti-dilutive.

### *Discontinued Operations*

On October 2, 2007, the Company sold substantially all of the assets of its consumer finance business segment, First Consumer Credit, Inc. As such, the Company has reclassified the operating results of its consumer finance segment as discontinued operations for all periods presented. The Company classifies a business component that has been disposed as a discontinued operation if the cash flows of the component are separately identifiable, have been eliminated from the Company's ongoing operations and the Company will no longer have any significant continuing involvement in the component. The results of operations of discontinued operations through the date of sale, including any gains or losses on disposition, are aggregated and presented on one line in the Consolidated Statements of Operations.

As a result of the disposition of the Company's consumer finance business, the Consolidated Balance Sheet as of December 31, 2007 does not include any assets or liabilities of discontinued operations. The cash flows of discontinued operations have not been reclassified. See Note 13 for additional information regarding the Company's discontinued operations.

### *Recent Accounting Pronouncements*

In December 2007, FASB issued Statement of Financial Accounting Standards No. 141, (revised 2007), "*Business Combinations*" ("SFAS No. 141(R)"), which continues the evolution toward fair value reporting and significantly changes the accounting for acquisitions that close beginning in 2009, both at the acquisition date and in subsequent periods. SFAS No. 141(R) introduces new accounting concepts and valuation complexities and many of the changes have the potential to generate greater earnings volatility after the acquisition. SFAS 141(R)

## 2. Summary of Significant Accounting Policies (Continued)

also requires that acquisition costs be expensed as incurred and restructuring costs be expensed in periods after the acquisition date. SFAS No. 141(R) will only affect the Company's financial condition or results of operations to the extent it has business combinations after the effective date.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 160, *"Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51"* ("SFAS No. 160"), which requires companies to measure an acquisition of noncontrolling (minority) interest at fair value in the equity section of the acquiring entity's balance sheet. The objective of SFAS No. 160 is to improve the comparability and transparency of financial data as well as to help prevent manipulation of earnings. The changes introduced by the new standards are likely to affect the planning and execution as well as the accounting and disclosure of merger transactions. The Company will adopt SFAS No. 160 on January 1, 2009. The adoption of SFAS No. 160 is not expected to have a material effect on the Company's results of operations or financial position.

In February 2008, FASB issued FASB Staff Position ("FSP") FAS 157-2, *"Effective Date of FASB Statement No. 157"*, which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed in the financial statements on a nonrecurring basis. The FSP partially defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for items within the scope of this FSP. The adoption of SFAS 157, as applied to financial assets and financial liabilities, did not have a material effect on the Company's financial position or results of operations. The Company has not applied the provisions of SFAS 157 to its nonfinancial assets and nonfinancial liabilities in accordance with FSP FAS 157-2. The Company will apply the provisions of SFAS 157 to these assets and liabilities beginning January 1, 2009. The adoption of this second phase of SFAS 157 in January 2009 will not have a material effect on the Company's results of operations or financial position.

In April 2008 the FASB issued FASB Staff Position ("FSP") No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors to be considered in developing renewal or extension assumptions used to determine the useful life of intangible assets under SFAS No. 142. Its intent is to improve the consistency between the useful life of an intangible asset and the period of expected cash flows used to measure its fair value. This FSP is effective for the Company on January 1, 2009. The Company does not expect FSP 142-3 to have a material impact on the consolidated financial statements.

In November 2008, the Financial Accounting Standards Board ratified a consensus opinion reached by the Emerging Issues Task Force (EITF) on EITF Issue 08-6, *"Equity Method Investment Accounting Considerations,"* to clarify accounting and impairment considerations involving equity method investments after the effective date of both FASB Statement 141 (revised 2007), *Business Combinations*, and FASB Statement 160, *Noncontrolling Interests in Consolidated Financial Statements*. EITF Issue 08-6 includes the Task Force's conclusions on how an equity method investor should (1) initially measure its equity method investment, (2) account for impairment charges recorded by its investee, and (3) account for shares issued by the investee. The Company adopted EITF Issue 08-6 effective January 1, 2009. EITF Issue 08-6 will only affect the Company's financial condition or results of operations if the Company makes any future investments accounted for under the equity method.

### 3. Information About Segments

The Company reports segment information in accordance with SFAS No. 131, "*Disclosures about Segments of an Enterprise and Related Information*". Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

Prior to September 30, 2007, the Company was engaged in two lines of business, the home improvement business and the consumer finance business. The Company's reporting segments were based on these same lines of business. Effective September 30, 2007, the Company sold substantially all of the assets of its consumer finance business, the results of which are reported in discontinued operations. (See Note 13.) Accordingly, the Company's current reporting segment consists only of the home improvement business. In the home improvement business, the Company manufactures or procures, designs, sells and installs custom kitchen and bathroom cabinet refacing products, and organization storage systems for closets and garages. The Company's home improvement products are marketed through a variety of sources including, direct mail, marriage mail, magazines, newspaper inserts and in-store displays at selected The Home Depot stores.

Since October 2003, the Company's home improvement operations have engaged in an expansion program with The Home Depot. In May 2006, the Company entered into a three year service provider agreement ("SPA") with The Home Depot which, among other items, provides that the Company will not offer its products or installation services under any brand or trademark other than as approved by The Home Depot. Prior to this agreement, in addition to the Company marketing its products under the brands "The Home Depot Kitchen and Bathroom Refacing" and "The Home Depot Installed Decks", the Company also marketed it products directly to consumers under the "CENTURY 21 Cabinet Refacing" and "CENTURY 21 Home Improvements" brands or the Company's own "Facelifters" and "Designer Deck" brands.

On February 28, 2008, the Company and The Home Depot mutually agreed to extend the termination date of the SPA to February 28, 2011 and to expand the Company's kitchen cabinet refacing and countertop products into additional markets in Ohio and Pennsylvania. In addition, the Company and The Home Depot mutually agreed to terminate the installed deck program under the SPA. As a result, effective February 29, 2008, the Company ceased receiving customer leads from The Home Depot for deck products in the Midwest, Boston, Connecticut, Virginia Beach and Atlanta markets, and on October 15, 2008, the Company ceased receiving customer leads in its remaining deck markets, including Northern Virginia, Maryland, Philadelphia, New Jersey and New York. The Company will continue to honor its warranty service obligations to existing The Home Depot deck customers.

The Company had planned to return to marketing its deck products under its own Designer Deck brand in the Northern Virginia, Maryland, Philadelphia and New Jersey markets after the phase-out of its deck products in The Home Depot stores. However, as a result of a number of factors, on November 11, 2008 the Company determined that upon completion of the existing deck orders it would cease offering deck products. The primary factors the Company considered in making its decision included (i) its growth strategy to concentrate its resources on offering products that can be distributed across a wider geographic footprint of its strategic partner, The Home Depot, (ii) the Company's expectation for continuing depressed demand for deck products as a result of the softness in the housing market, and (iii) the immediate challenge and expense of reintroducing the Company's Designer Deck brand during the seasonal downturn for deck sales.

### 3. Information About Segments (Continued)

As of December 31, 2008, the Company had completed the manufacture, but not installation, of all pending deck orders. The Company is actively marketing for sale its Woodbridge, Virginia deck manufacturing facility and equipment. In connection with the Company's decision to cease offering deck products, the Company has recorded charges of approximately $514,000 in 2008 including $150,000 for write-down of equipment assets, $245,000 for write-down of raw materials inventories, $89,000 for write-off of in-store deck displays and $30,000 for severance costs and other shutdown related expenses. The Company's Woodbridge manufacturing facility did not require an impairment charge at December 31, 2008 as the carrying value was determined to be lower than the fair value. Management has considered all information available at the time the estimate is made in determining the fair value of assets held for sale; however, the fair value ultimately realized upon the sale of the assets could differ from the estimated amounts reflected in our Consolidated Balance Sheets.

In July 2008 the Company and The Home Depot began testing a pilot program in the Dallas market to offer a new range of home storage organization products for bedroom closets and garages. The Company is currently working with The Home Depot to provide for a roll out of these products to be offered in markets where the Company currently offers its kitchen refacing products. The Company will begin this roll out in the first quarter of 2009 and complete the roll out in the third quarter of 2009. In connection with this product category, the Company purchased a 33.33% membership interest in Blue Viking Storage, LLC, a distributor of garage organizer systems and accessories. In conjunction with the membership interest, the Company entered into a marketing consulting agreement with Blue Viking in which Blue Viking will provide the Company sales and marketing consulting to support its entry and expansion into the garage and home storage industry.

In December 2008 the Company entered into a franchise agreement (the "Franchise Agreement") with Harris Research, Inc., a wholly owned subsidiary of The Home Depot. The Franchise Agreement allows for the Company to market, sell and apply a wood kitchen cabinet and wood floor refinishing system through selected The Home Depot Stores in the Boston, Massachusetts, Long Island, New York, and Philadelphia, Pennsylvania markets under the brand name N-Hance. The N-Hance wood renewal system utilizes a proprietary process involving the application of N-Hance cleaners, neutralizers, repair/fillers, coloring agents, sealers and finishes. In connection with the Franchise agreement, the Company paid a franchise fee of approximately $80,000 which is included in "Other assets" on the Consolidated Balance Sheet.

Revenues attributable to each of the Company's product lines are as follows (in thousands):

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Home Improvement Product Lines: | | | |
| Kitchen refacing and countertops | $110,543 | $ 92,634 | $ 82,786 |
| Bathroom refacing | 8,981 | 10,298 | 11,174 |
| Decks | 12,665 | 20,343 | 26,789 |
| Organizers | 314 | — | — |
| Other | — | — | 62 |
| Total Home Improvement revenues | $132,503 | $123,275 | $120,811 |

### 3. Information About Segments (Continued)

The percentage of home improvement revenues attributable to our major brands are as follows:

| | Year ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| The Home Depot | 100% | 100% | 94% |
| Century 21 Home Improvements | — | — | 2 |
| Company Brands | — | — | 4 |
| Total | 100% | 100% | 100% |

Our home improvement business is subject to seasonal trends. The generation of new orders through our relationship with The Home Depot for our kitchen and bath products typically declines in the last six weeks of the year during the holiday season, which negatively impacts our first quarter revenues and net income. Extreme weather conditions in the markets we serve occasionally impact our revenues and net income.

### 4. Fair Value

Effective January 1, 2008, the Company adopted SFAS No. 157. SFAS No. 157 clarifies that fair value is a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value as follows:

**Level 1**—Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2**—Include other inputs that are directly or indirectly observable in the marketplace.

**Level 3**—Unobservable inputs which are supported by little or no market activity.

In accordance with SFAS No. 157, we measure our cash equivalents and marketable securities at fair value using quoted market prices.

Assets measured at fair value on a recurring basis are summarized below (in thousands):

| | Fair value measurement at reporting date using | | | |
|---|---|---|---|---|
| | December 31, 2008 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| **Cash equivalents:** | | | | |
| Money market mutual funds | $3,909,506 | $3,909,506 | — | — |
| **Marketable securities:** | | | | |
| Municipal Bond funds | $2,036,049 | $2,036,049 | — | — |
| **Total assets** | $5,945,555 | $5,945,555 | — | — |

## 5. Inventories

Inventories, net of applicable reserves, consisted of the following:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Raw materials | $2,292,598 | $2,897,093 |
| Work-in-progress | 1,246,039 | 2,310,612 |
| Total | $3,538,637 | $5,207,705 |

In connection with the Company's decision in November 2008 to cease offering deck products, the Company recorded a charge of approximately $245,000 to write-down deck raw materials to their expected net realizable value. The charge reflects the Company's remaining deck raw materials at December 31, 2008 for which there are no remaining deck product sales orders to be manufactured. The Company has estimated the net realizable value of the remaining inventory based upon current offers it has received from buyers for certain materials. The write-down charge is included in "Costs of remodeling contracts" in the Company's Consolidated Statements of Operations for the year ended December 31, 2008.

## 6. Property, Plant, and Equipment

Property, plant, and equipment consisted of the following:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Buildings and improvements | $ 735,931 | $ 3,644,181 |
| Machinery and equipment | 3,009,413 | 3,709,805 |
| Furniture, fixtures, and computer equipment | 5,377,186 | 5,061,718 |
| Leasehold improvements | 573,247 | 472,354 |
| Construction in process | 48,755 | 74,560 |
| | 9,744,532 | 12,962,618 |
| Less accumulated depreciation and amortization | (7,275,683) | (7,805,655) |
| | 2,468,849 | 5,156,963 |
| Land | 50,000 | 400,000 |
| | $ 2,518,849 | $ 5,556,963 |

Depreciation and amortization expense related to property, plant and equipment was approximately $1,377,000, $1,258,000, and $1,287,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

We record impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets may be impaired and the undiscounted future cash flows estimated to be generated by these assets are less than the assets' net book value. If impairment occurs, the loss is measured by comparing the fair value of the asset to its carrying amount. In connection with the Company's decision to cease offering deck products, the Company recorded a charge of approximately $239,000 to write-down manufacturing equipment assets at the Company's Woodbridge, Virginia deck manufacturing facility and in-store displays at certain The Home Depot stores. The charge is included in depreciation expense in the Company's Consolidated Statement of Operations for the year ended December 31, 2008.

## 6. Property, Plant, and Equipment (Continued)

At December 31, 2008, the Company was actively marketing for sale of the deck manufacturing equipment and facility. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* the Company has classified these assets as Assets Held For Sale on the Company's Consolidated Balance Sheet.

## 7. Credit Facilities

Debt under the Company's credit facilities consisted of the following:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Frost Term loan | $1,133,330 | $1,200,000 |
| Mortgage payable in monthly principal and interest payments of $19,398 through January 1, 2018 | 1,545,556 | 1,661,673 |
| Other | 66,004 | — |
| Total Long-Term Debt | 2,744,890 | 2,861,673 |
| Less Current Portion | 214,254 | 189,454 |
| Long-Term Portion | $2,530,636 | $2,672,219 |

Maturities of debt under the Company's credit facilities as of December 31, 2008, are as follows:

| | |
|---|---|
| 2009 | $ 214,254 |
| 2010 | 227,084 |
| 2011 | 1,131,530 |
| 2012 | 170,179 |
| 2013 | 181,641 |
| Thereafter | 820,202 |
| Total | $2,744,890 |

### *Frost Loan Agreement*

On December 18, 2008 the Company amended and restated its loan agreement (the "Loan Agreement") with Frost National Bank ("Frost Bank"). The Loan Agreement as amended provides for a $4 million borrowing base line of credit (the "Borrowing Base Line of Credit"). The Company's existing term loan in the original amount of $1,200,000 (the "Term Loan") was not affected by the amendment. The Loan Agreement and related notes are secured by substantially all of the assets of the Company and its subsidiaries, and the Company's subsidiaries are guarantors.

Term Loan—In February 2006 the Company exercised its option to purchase its kitchen manufacturing facility in Charles City, Virginia. Interest only on the term note is payable monthly at the London Interbank Offered Rate, or LIBOR, plus 2.0% (3.18% at December 31, 2008 and 6.83% at December 31, 2007) until February 10, 2008. Thereafter, a monthly principal payment of $6,667 is payable plus accrued interest until February 10, 2011, at which time any outstanding principal and accrued interest is due and payable. At December 31, 2008, the Company had outstanding borrowings of $1,133,000 under the term loan.

## 7. Credit Facilities (Continued)

Borrowing Base Line of Credit—The Borrowing Base Line of Credit allows borrowings up to $4 million for working capital. Borrowings and required payments under the Borrowing Base Line of Credit are based upon an asset formula involving accounts receivable and inventory. At December 31, 2008 the Company had no balance outstanding under the Borrowing Base Line of Credit, and had a borrowing capacity of approximately $3,104,000.

Interest on the Borrowing Base Line of Credit is payable monthly on the unpaid balance at LIBOR, plus 2%, through April 2, 2009, and thereafter, at the prime rate of the lender, plus one half of one percent. The Borrowing Base Line of Credit matures May 2, 2010, at which time any outstanding principal and accrued interest is due and payable.

The Company's Frost credit facilities contain covenants, which among other matters, (i) limit the Company's ability to incur indebtedness, merge, consolidate and sell assets; (ii) require the Company to satisfy certain ratios related to tangible net worth and fixed charge coverage; and (iii) limit the Company from making any acquisition which requires in any fiscal year $1.0 million cash or $2.0 million of cash and non-cash consideration. The Company is in compliance with all restrictive covenants at December 31, 2008.

### *Mortgage Payable*

The Company has a mortgage with GE Capital Business Asset Funding on its Woodbridge, Virginia manufacturing facility. The mortgage is secured by the property. Among other provisions, (i) interest on the mortgage is 7.25%, (ii) the mortgage is subject to a prepayment premium, and (iii) the mortgage is guaranteed by the Company. The mortgage is payable in monthly principal and interest payments of $19,398 through January 1, 2018.

In connection with the Company's decision to cease offering deck products, the Company is offering for sale its Woodbridge facility. Upon sale, the Company's mortgage on the building will be retired using the proceeds from the sale.

### *Other*

In December 2008 the Company entered into a five year franchise agreement (the "Franchise Agreement") with Harris Research, Inc., a wholly owned subsidiary of The Home Depot. The Franchise Agreement provides for the Company to market, sell and install a wood kitchen cabinet and wood floor refinishing system in selected The Home Depot Stores under the brand name N-Hance. The Franchise agreement provides for the Company to pay a franchise fee of $80,255 of which $66,004 is financed. The interest rate on the note is 8.0%. The note is payable in 56 monthly principal and interest payments commencing April 1, 2009 in the amount of $1,416.

## 8. Commitments and Contingencies

### *Operating Leases*

The Company operates principally in leased facilities, and in most cases, management expects that leases currently in effect will be renewed or replaced by other leases of a similar nature and term. Escalation charges imposed by lease agreements are not significant. Rent expense recognized under non-cancelable operating leases was approximately $3,618,822, $3,530,000 and $3,258,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

## 8. Commitments and Contingencies (Continued)

Commitments for future minimum rental payments required under non-cancelable operating leases with initial terms in excess of one year as of December 31, 2008, are as follows:

| | |
|---|---|
| 2009 | $3,010,782 |
| 2010 | 2,544,997 |
| 2011 | 1,630,939 |
| 2012 | 769,872 |
| 2013 | 225,698 |
| Total minimum lease payments | $8,182,288 |

### *Litigation*

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the consolidated financial position or results of operations of the Company.

### *Employment Agreements*

The Company has employment agreements with certain of its officers and key employees with terms which range from one to three years. The agreements generally provide for annual salaries and for salary continuation for a specified number of months under certain circumstances, including a change in control of the Company.

## 9. Capitalization

U.S. Home Systems, Inc. has authorized 30,000,000 shares of $0.001 par value common stock and 1,000,000 shares of $0.001 par value preferred stock.

In August 2007, the Board of Directors authorized the repurchase of up to $5 million of the Company's outstanding stock. Shares of common stock repurchased by the Company are recorded at cost as treasury stock and result in a reduction of stockholders' equity in the Consolidated Balance Sheets. Cumulative repurchases through December 31, 2007 were 737,093 shares at a cost of approximately $4,985,000. The Company does not intend to make any additional purchases under this authorization. On March 13, 2008, the Board of Directors authorized the cancellation of the 737,093 shares. The cancelled treasury shares were reclassified as authorized and un-issued shares.

On March 13, 2008, the Board of Directors also authorized an additional repurchase of the Company's outstanding stock up to $2 million. Any repurchase under the Company's stock repurchase program may be made in the open market at such times and such prices as the Company may determine appropriate. Cumulative repurchases under this authorization through December 31, 2008 were 312,253 shares at a cost of approximately $974,000.

## 10. Income Taxes

The significant components of the Company's deferred tax assets and liabilities at December 31, 2008 and 2007 are as follows:

| | 2008 | 2007 |
|---|---|---|
| Deferred tax assets: | | |
| Reserve for doubtful accounts | $ 64,260 | $ 73,766 |
| Compensation accruals | 209,600 | 263,741 |
| Accruals and reserves | 224,656 | 318,417 |
| Inventory reserves | 156,165 | 88,581 |
| Other | 37,791 | 68,919 |
| Total gross deferred tax assets | 692,472 | 813,424 |
| Deferred tax liabilities: | | |
| Prepaid expenses | (145,188) | (181,138) |
| Depreciation | (288,489) | (282,332) |
| Total gross deferred tax liabilities | (433,677) | (463,470) |
| Net deferred tax asset | $ 258,795 | $ 349,954 |
| Deferred taxes consisted of the following: | | |
| Current deferred income taxes | $ 568,737 | $ 645,404 |
| Noncurrent deferred income taxes | (309,942) | (295,450) |
| Net deferred tax asset | $ 258,795 | $ 349,954 |

The provision (benefit) for income taxes from continuing operations at the Company's effective tax rate differs from the provision for income taxes at the federal statutory tax rate (34%) for the following reasons:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Federal tax at statutory rate | $473,960 | $1,398,147 | $2,320,824 |
| State income taxes, net of federal tax benefit | 138,226 | 306,524 | 368,068 |
| Other | 6,756 | (3,363) | 40,330 |
| Total income taxes | $618,942 | $1,701,308 | $2,729,222 |

## 10. Income Taxes (Continued)

The provision (benefit) for income taxes consisted of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Current: | | | |
| Federal | | | |
| Continuing operations | $367,580 | $1,243,130 | $ 3,383,624 |
| Discontinued operations | (255) | 451,265 | (56,928) |
| | 367,325 | 1,694,395 | 3,326,696 |
| State | | | |
| Continuing operations | 160,203 | 518,513 | 272,602 |
| Discontinued operations | — | 17,227 | 15,350 |
| | 160,203 | 535,740 | 287,952 |
| Total current | 527,528 | 2,230,135 | 3,614,648 |
| Deferred: | | | |
| Federal | | | |
| Continuing operations | 74,408 | (19,570) | (1,218,296) |
| Discontinued operations | — | 98,828 | 92,329 |
| | 74,408 | 79,258 | (1,125,967) |
| State | | | |
| Continuing operations | 16,751 | (40,765) | 291,292 |
| Discontinued operations | — | 18,940 | 17,544 |
| | 16,751 | (21,825) | 308,836 |
| Total deferred | 91,159 | 57,433 | (817,131) |
| Total income taxes from continuing operations | 618,942 | 1,701,308 | 2,729,222 |
| Total income taxes from discontinued operations | (255) | 586,260 | 68,295 |
| Total income taxes | $618,687 | $2,287,568 | $ 2,797,517 |

## 11. Employee Savings Plan

The Company maintains an employee savings plan under which qualified participants make contributions by salary reduction pursuant to Section 401(k) of the Internal Revenue Code. At the discretion of the Board of Directors, the Company may contribute up to a maximum of 6% of base salary. Employee contributions vest immediately, while contributions made by the Company fully vest after five years of service. For the year ended December 31, 2006, the Company made contributions to the employee savings plan of $83,000. The Company did not make contributions for the years ended December 31, 2008 and 2007.

## 12. Stock Based Incentive Plans

The Company's stock-based incentive plans provide for the grant of incentive stock options ("ISOs") as defined in Section 422 of the Internal Revenue Code of 1986, as amended, nonqualified stock options ("NSOs") and restricted stock awards (collectively referred to as "Awards"). Awards are administered by the Company's Compensation Committee of the Board of Directors. The purpose of the Company's Awards is to provide employees, directors and advisors with additional incentives by increasing their proprietary interest in the Company.

## 12. Stock Based Incentive Plans (Continued)

Each stock option is subject to the terms and provisions of an option agreement which specifies the period and number of shares exercisable. Options are generally exercisable in installments pursuant to a vesting schedule as determined by the Board of Directors, usually over a period of three to five years. The option agreements may provide for acceleration of exercisability in the event of a change in control of the Company. No option is exercisable later than 10 years after the date of grant. The exercise prices for options granted under the plans may be no less than the fair market value of the common stock on the date of grant. The Company generally issues authorized but previously unissued shares to satisfy stock option exercises.

Pursuant to the Company's Restricted Stock Plan, the Company's employees and directors may be granted restricted stock awards under such terms as determined by the compensation committee. The compensation committee is authorized to determine the vesting schedule, rights of repurchase, and other terms, conditions and restrictions on the common stock awarded under the Restricted Stock Plan. Such terms may include acceleration of vesting or termination of rights to repurchase shares upon events such as death or disability of a participant or termination of a participant's employment or term of board service. A participant to whom an award is made will generally have all the rights of a stockholder with respect to such shares, including the right to vote and to receive dividends, except as set forth in the applicable award agreement. The Compensation Committee is authorized to grant up to a maximum of 500,000 shares of common stock. At December 31, 2008, 366,495 shares were available for issuance.

Non-employee directors are required to receive at least $5,000 of their annual retainer in the form of shares of the Company's common stock issued under the Restricted Stock Plan and may elect to receive restricted stock in lieu of their quarterly cash compensation. During the year ended December 31, 2008, the Company issued 19,930 shares to non-employee directors as compensation and recorded approximately $73,000 of expense related to these shares. The restricted shares were issued without forfeiture terms and were fully vested upon issuance.

### *Compensation Cost Recognized*

Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective method. Under SFAS No. 123R the Company is required to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The Company recognizes compensation expense for awards on a ratable basis over the vesting period.

For the years ended December 31, 2008, 2007 and 2006, stock based compensation consisted of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Stock compensation from: | | | |
| Stock Options | $ 39,000 | $ 11,000 | $200,000 |
| Stock Awards | 254,000 | 326,000 | 217,000 |
| Total Compensation Cost | $293,000 | $337,000 | $417,000 |
| Tax Benefit Recognized | $ 99,000 | $127,000 | $ 85,000 |

### *Stock Options*

The Company's 2000 Stock Compensation Plan (the "Plan") provides for up to 3,000,000 shares of common stock with respect to which options may be granted under the Plan, subject to appropriate equitable adjustment in

## 12. Stock Based Incentive Plans (Continued)

the event of a reorganization, stock split, stock dividend, reclassification or other change affecting the Company's common stock as provided in Section 15 of the Plan. The Board of Directors of the Company approved further restricting the number of shares available for options under the Plan to 20% of the outstanding shares of common stock of the Company. The Board of Directors retained the authority to increase the number of shares available for options under the Plan from time to time as may be necessary in the future to provide ample shares for options under the Plan for the Company's employees, directors and advisors. At December 31, 2008, options to purchase 581,382 shares of common stock were available for grant under the Plan.

The following information summarizes stock options outstanding and exercisable at December 31, 2008:

| | Outstanding | | | Exercisable | |
|---|---|---|---|---|---|
| | No. of Underlying Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | No. of Underlying Shares | Weighted Average Exercise Price |
| Range of Exercise Prices | | | | | |
| $1.8500 - $ 1.8500 | 198,000 | $1.85 | 9.86 | 66,006 | $1.85 |
| $3.4400 - $ 4.9500 | 63,705 | $3.60 | 2.30 | 63,705 | $3.60 |
| $4.9501 - $ 6.7100 | 22,768 | $6.12 | 4.91 | 22,768 | $6.12 |
| $6.7101 - $ 8.5800 | 78,001 | $8.17 | 3.00 | 78,001 | $8.17 |
| $8.5801 - $10.4800 | 9,364 | $9.92 | .52 | 9,364 | $9.92 |
| | 371,838 | $3.94 | 6.59 | 239,844 | $5.09 |

A summary of the Company's stock option activity and related information for the years ended December 31, 2008, 2007 and 2006, are as follows:

| | 2008 | | | 2007 | | | 2006 | | |
|---|---|---|---|---|---|---|---|---|---|
| | No. of Underlying Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value ($000) | No. of Underlying Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value ($000) | No. of Underlying Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value ($000) |
| Outstanding at beginning of year | 234,194 | $6.09 | | 358,115 | $6.15 | | 650,979 | $4.86 | |
| Granted | 198,000 | 1.85 | | — | — | | 53,001 | $8.49 | |
| Exercised | — | — | | (111,375) | 6.11 | | (325,693) | $3.97 | |
| Forfeited, canceled or Expired | (60,356) | 5.42 | | (12,546) | 7.66 | | (20,172) | $5.83 | |
| Outstanding at end of year | 371,838 | $3.94 | $147 | 234,194 | $6.09 | $119 | 358,115 | $6.15 | $1,856 |
| Exercisable at end of year | 239,844 | $5.09 | $ 49 | 227,247 | $6.07 | $119 | 325,349 | $6.17 | $1,682 |
| Weighted average fair value of options granted during the year | $ 0.50 | — | — | — | — | — | $ 2.52 | — | — |

During 2007, 20,000 shares were exercised by tendering 8,119 shares of the Company's common stock to pay the exercise price. The total intrinsic value of options exercised (the amount by which the stock price exceeded the exercise price of the option on the date of exercise) during 2007 and 2006 was $786,000 and $1,569,000, respectively. There were no options exercised during 2008.

## 12. Stock Based Incentive Plans (Continued)

During 2008 and 2006, the Company granted to employees and directors options to purchase 198,000 and 53,001 shares of the Company's common stock, respectively. No options were granted in 2007. The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model. The fair value of options granted during the years ended December 31, 2008 and 2006 were determined with the following assumptions:

| | Assumptions | |
|---|---|---|
| | 2008 | 2006 |
| Weighted average fair value of grants | $ 0.50 | $ 2.52 |
| Risk-free rate of return | 2.97% | 5.0% |
| Expected life | 3 years | 3 years |
| Expected volatility | 35% | 35% |
| Expected dividend yield | 0% | 0% |

The risk-free interest rate assumption is determined using the Federal Reserve nominal rates of U.S. Treasury zero coupon bonds with maturities similar to the expected term of the award being valued. For options granted in 2008, the risk-free interest rate utilized was 0.92% for the first year and 2.97% for remainder of the expected life of the options. The expected term of options granted is based on the Company's historical exercise and termination patterns, and represents the period of time that options granted are expected to be outstanding. Expected volatility is based upon management's estimate of future volatility for the Company's stock price. When estimating future volatility, the Company considers a number of factors, including the Company's historical stock price volatility, the Company's expected growth under its program with The Home Depot and the economic environment. The Company has not declared any dividends during 2008, 2007 and 2006.

Additionally, SFAS 123(R) requires the Company to estimate pre-vesting forfeitures at the time of grant and periodically revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company records stock-based compensation expense only for those awards expected to vest using an estimated forfeiture rate based on our historical pre-vesting forfeiture data.

Compensation expense related to stock options was approximately $39,000, $11,000, and $200,000 for the years ended December 31, 2008, 2007 and 2006, respectively. As of December 31, 2008, the Company had $62,000 total unrecognized compensation cost related to non-vested stock options which is expected to be recognized over a weighted average period of 1.86 years.

### *Restricted Stock Awards*

For the years ended December 31, 2008, 2007 and 2006, restricted stock award activity is as follows:

| | 2008 | | 2007 | | 2006 | |
|---|---|---|---|---|---|---|
| | No. of Underlying Shares | Fair Value at Date of Grant | No. of Underlying Shares | Fair Value at Date of Grant | No. of Underlying Shares | Fair Value at Date of Grant |
| Outstanding at beginning of year | 44,758 | $ 9.33 | 47,333 | $ 7.67 | 45,542 | $5.85 |
| Granted | 19,930 | 3.67 | 31,662 | $11.08 | 28,438 | $9.42 |
| Vested | (44,136) | 6.36 | (33,737) | $ 8.64 | (26,138) | $6.45 |
| Forfeited, canceled or expired | (1,950) | 7.82 | (500) | $ 5.79 | (509) | $6.14 |
| Outstanding at end of year | 18,602 | $10.46 | 44,758 | $ 9.33 | 47,333 | $7.66 |

## 12. Stock Based Incentive Plans (Continued)

The Company recognizes compensation expense for restricted stock awards on a ratable basis over the vesting period. Compensation expense related to restricted stock awards was approximately $254,000 ($155,000 net of tax benefit), $326,000 ($199,000 net of tax benefit) and $217,000 ($132,000 net of tax benefit) for the years ended December 31, 2008, 2007 and 2006, respectively. In 2008, the Company had excess tax expense from restricted stock classified as a financing cash in flow of approximately $32,000.

As of December 31, 2008, the Company had $54,000 total unrecognized compensation cost related to restricted stock awards which is expected to be recognized over a weighted average period of .75 years.

The Company's Awards are not performance based and vest with continued employment. Awards are generally subject to forfeiture in the event of termination of employment.

## 13. Discontinued Operations

Effective September 30, 2007, the Company and First Consumer Credit, Inc. (FCC), the consumer finance subsidiary of the Company, entered into an Asset Purchase Agreement with FCC Finance, LLC ("FCC-Finance") whereby FCC sold substantially all of its assets to FCC-Finance for approximately $2.6 million in a buyout led by management of the consumer finance subsidiary. Included among the assets sold were FCC's portfolio of retail installment contracts (RIOs), FCC's servicing asset, furniture, fixtures, equipment, goodwill and certain intellectual property. Assets retained included cash and certain accounts receivable.

Concurrent with the transaction, FCC terminated its rights under the master participation agreement, dated as of November 2, 2006 (the "Participation Agreement") between FCC and FCC Investment Trust I (the "Trust"), an unaffiliated financial institution. The Participation Agreement provided FCC with a preferred rate of return on its non-owner participation interest investment in a RIO portfolio owned by the Trust. Upon termination of the Participation Agreement, FCC received a return of its remaining investment principal balance of approximately $1,577,000.

In connection with the transaction, FCC recognized a pre-tax loss of $1,370,000, which included a write down of goodwill related to the finance business unit as follows (in thousands):

| | |
|---|---|
| Assets sold: | |
| Assets other than goodwill | $ 255 |
| Goodwill | 3,767 |
| Total assets | 4,022 |
| Proceeds from sale, net of legal expenses of $10 | 2,652 |
| Loss on sale | $1,370 |

The goodwill associated with the finance business did not qualify as a tax deduction under tax regulations. Consequently, for income tax purposes, the transaction resulted in a taxable gain and the Company recognized an income tax liability of approximately $910,000 at December 31, 2007.

The Company also entered into a Transition Services Agreement with FCC-Finance to provide certain services to assist the purchaser with the transition of the business operations. These services primarily included administrative and information systems support. The Company's costs to provide these services are reimbursable by the purchaser at the Company's cost. The transition was substantially complete as of December 31, 2007.

As a result of the transaction, the financial operating results of FCC for all periods have been reclassified as discontinued operations in the accompanying statements of operations.

## 14. Income (loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share for the periods indicated:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Income (loss) applicable to common stockholders: | | | |
| Income from continuing operations | $ 775,057 | $ 2,410,890 | $4,096,732 |
| Income (loss) from discontinued operations | (494) | (2,709,675) | 122,692 |
| Income (loss) applicable to common stockholders | $ 774,563 | $ (298,785) | $4,219,424 |
| Weighted average shares outstanding—basic | 7,558,840 | 8,160,702 | 8,114,598 |
| Effect of dilutive securities | 24,031 | 116,700 | 180,635 |
| Weighted average shares outstanding—diluted | 7,582,871 | 8,277,402 | 8,295,233 |
| Net income (loss) per basic share: | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.50 |
| Discontinued operations | — | (0.33) | 0.02 |
| Net income (loss) per basic share | $ 0.10 | $ (0.04) | $ 0.52 |
| Net income (loss) per diluted share: | | | |
| Continuing operations | $ 0.10 | $ 0.29 | $ 0.49 |
| Discontinued operations | — | (0.33) | 0.02 |
| Net income (loss) per diluted share | $ 0.10 | $ (0.04) | $ 0.51 |

The calculation of diluted net income (loss) per share excludes all anti-dilutive shares. For the years ended December 31, 2008, 2007 and 2006, approximately 140,282, 5,253 and 20,000 common stock equivalents, respectively, were not included in the computation of diluted net income per share because the effect would have been anti-dilutive.

## 15. Selected Quarterly Financial Information (unaudited)

The following presents selected quarterly financial information from the Company's unaudited consolidated financial statements for the periods specified below:

| | (In thousands, except per share amounts) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2008 | | | | 2007 | | | |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Revenues | $ 31,947 | $ 35,485 | $ 34,982 | $ 30,089 | $ 28,084 | $ 31,601 | $ 34,249 | $ 29,341 |
| Gross Profit | 16,560 | 18,924 | 18,281 | 15,874 | 14,723 | 17,186 | 17,760 | 14,803 |
| Income (loss) from continuing operations | (5) | 720 | 600 | (540) | 419 | 1,189 | 1,236 | (434) |
| Discontinued operations | — | — | — | — | (187) | (88) | (2,466) | 32 |
| Net income (loss) | (5) | 720 | 600 | (540) | 232 | 1,101 | (1,230) | (402) |
| Net income (loss) from continuing operations per common share: | | | | | | | | |
| Basic | $ .00 | $ .09 | $ .08 | $ (.07) | $ 0.05 | $ 0.14 | $ 0.15 | $ (0.05) |
| Diluted | $ .00 | $ .09 | $ .08 | $ (.07) | $ 0.05 | $ 0.14 | $ 0.15 | $ (0.05) |
| Discontinued operations per common share: | | | | | | | | |
| Basic | $ .00 | $ .00 | $ .00 | $ .00 | $ (0.02) | $ (0.01) | $ (0.30) | $ 0.00 |
| Diluted | $ .00 | $ .00 | $ .00 | $ .00 | $ (0.02) | $ (0.01) | $ (0.30) | $ 0.00 |
| Net income (loss) per common share: | | | | | | | | |
| Basic | $ .00 | $ .09 | $ .08 | $ (.07) | $ 0.03 | $ 0.13 | $ (0.15) | $ (0.05) |
| Diluted | $ .00 | $ .09 | $ .08 | $ (.07) | $ 0.03 | $ 0.13 | $ (0.15) | $ (0.05) |
| Weighted average common shares outstanding | | | | | | | | |
| Basic | 7,632,862 | 7,615,984 | 7,560,231 | 7,427,708 | 8,248,571 | 8,317,910 | 8,229,691 | 7,851,257 |
| Diluted | 7,632,862 | 7,621,046 | 7,566,459 | 7,427,708 | 8,423,843 | 8,464,828 | 8,229,691 | 7,851,257 |

## 16. Subsequent Events

On February 4, 2009, the Company reported the resignation of Peter T. Bulger as President and Chief Operating Officer of the Company.

The Company and Mr. Bulger entered into a Separation Agreement and General Release of Claims ("Agreement"). Pursuant to the terms of the Agreement the Company shall pay Mr. Bulger a total of $383,250 payable as follows:

(1) $50,000 payable on February 24, 2009 in consideration of the release and waiver of claims as defined in the Agreement;

(2) $33,250 payable on February 24, 2009 to Mr. Bulger for his consulting services through February 2, 2010; and

(3) $300,000 payable $25,000 per month beginning March 2, 2009 and ending on February 2, 2010 in consideration of certain restrictive covenants agreed to by Mr. Bulger.

[THIS PAGE INTENTIONALLY LEFT BLANK]

[THIS PAGE INTENTIONALLY LEFT BLANK]

# CORPORATE AND SHAREHOLDER INFORMATION

## EXECUTIVE OFFICERS

- Murray H. Gross
  Chairman, President and CEO
- Robert A. DeFronzo
  Secretary, Treasurer and CFO
- Steven L. Gross
  Executive Vice President – Chief Marketing Officer
- Richard B. Goodner
  Vice President – Legal Affairs and General Counsel

## BOARD OF DIRECTORS

- Murray H. Gross
  Chairman
- Richard W. Griner
  Private Investments
- Donald A. Buchholz
  Chairman, SWS Group, Inc.
- Larry A. Jobe
  Chairman, Legal Network, Ltd.
- Kenneth W. Murphy
  Managing Partner, Label Source, Ltd.

## INVESTOR RELATIONS

Hayden Communications, Inc.
1401 Havens Drive
Suite 100
North Myrtle Beach, SC 29582
Brett Maas 843-272-4653
brett@haydenir.com

## ANNUAL MEETING

The annual meeting of U.S. Homes Systems, Inc. shareholders will be held June 5, 2009 at 10:00 AM local time at 405 State Highway 121 Bypass, Building A, Suite 250, Lewisville, Texas 75067

## CORPORATE OFFICES

405 State Highway 121 Bypass, Building A, Suite 250
Lewisville, Texas 75067

## COMMON STOCK

Listed on the NASDAQ Global Market under the symbol USHS.

## TRANSFER AGENT

Corporate Stock Transfer
3200 Cherry Creek Drive South
Suite 430
Denver, Colorado 80209

Communication concerning the transfer of shares, lost certificates, duplicate mailing, or change of address should be directed to the transfer agent

## LEGAL COUNSEL

Jackson Walker, LLP
Dallas, Texas

## AUDITORS

Grant Thornton, LLP
Dallas, Texas

US HOME SYSTEMS