Consolidated Financial Statements

State National Companies, Inc.
Years Ended December 31, 2012 and 2011
With Report of Independent Auditors

Ernst & Young LLP

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Contents

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Report of Independent Auditors

The Board of Directors and Shareholders
State National Companies, Inc.

We have audited the accompanying consolidated financial statements of State National Companies, Inc., which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's responsibility for the financial statements

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

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of State National Companies, Inc. at December 31, 2012 and 2011, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 29, 2013

State National Companies, Inc.

Consolidated Balance Sheets

	December 31 2012	2011
Assets		
Investments:		
Fixed-maturity securities – available-for-sale, at fair value (amortized cost: 2012 – $176,099,025; 2011 – $178,204,466)	**$ 184,899,310**	$ 186,552,157
Equity securities – available-for-sale, at fair value (cost: 2012 – $1,342,490; 2011 – $1,211,182)	**2,043,715**	1,722,079
Total investments	**186,943,025**	188,274,236
Cash and cash equivalents	**54,064,676**	40,658,354
Restricted cash and investments	**8,070,696**	6,279,717
Accounts receivable from agents, net	**8,919,468**	12,584,131
Accounts receivable from insurance companies	**1,011,646**	1,238,861
Deferred acquisition costs	**1,176,333**	4,110,647
Reinsurance receivables	**1,201,052,586**	1,074,404,137
Property and equipment, net	**20,458,844**	20,914,848
Interest receivable	**1,263,750**	1,380,748
Premium taxes receivable	**2,336,846**	1,476,090
Income taxes receivable	**–**	68,242
Deferred income taxes, net	**–**	475,289
Goodwill and intangible assets, net	**9,240,764**	10,648,324
Other assets	**2,989,117**	3,898,459
Total assets	**$ 1,497,527,751**	$ 1,366,412,083

State National Companies, Inc.

Consolidated Balance Sheets (continued)

	December 31 2012	December 31 2011
Liabilities		
Unpaid losses and loss adjustment expenses	**$ 975,708,154**	$ 806,125,401
Unearned premiums	**253,637,993**	293,924,236
Allowance for policy cancellations	**32,774,573**	27,510,893
Deferred ceding commissions	**11,961,640**	13,868,795
Accounts payable to agents	**2,064,063**	7,414,799
Accounts payable to insurance companies	**4,075,695**	2,525,241
Subordinated debentures	**52,000,000**	52,000,000
Premium taxes payable	**2,767,625**	3,742,650
Income taxes payable	**289,027**	–
Deferred income taxes	**533,233**	–
Other liabilities	**19,354,876**	18,977,830
Other payables, affiliate	**138,423**	235,624
Total liabilities	**1,355,305,302**	1,226,325,469
Shareholders' equity		
Common stock, $.001 par value (100,000 shares authorized, 55,200 shares issued, of which 8,764 are being held as treasury stock)	**55**	55
Additional paid-in capital	**24,408,268**	24,408,268
Retained earnings	**121,413,519**	119,707,167
Less treasury stock (8,764 shares at cost)	**(10,000,000)**	(10,000,000)
Accumulated other comprehensive income	**6,400,607**	5,971,124
Total shareholders' equity	**142,222,449**	140,086,614
Total liabilities and shareholders' equity	**$ 1,497,527,751**	$ 1,366,412,083

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Income

	Year Ended December 31	
	2012	**2011**
Revenues:		
Premiums earned	**$ 78,096,092**	$ 81,974,385
Commission income	**2,406,067**	2,246,723
Ceding commissions	**32,378,675**	30,454,770
Net investment income	**5,525,067**	6,216,889
Realized gains on sale of equipment	**120,592**	91,935
Realized gain on sale of affiliate	–	663,234
Realized net investment gains	**1,309,092**	439,018
Other income	**2,287,049**	2,661,835
Total revenues	**122,122,634**	124,748,789
Expenses:		
Losses and loss adjustment expenses	**28,988,853**	29,632,147
Commissions	**2,921,287**	4,351,649
Taxes, licenses, and fees	**2,393,624**	2,245,151
General and administrative	**64,854,160**	53,283,369
Interest expense	**2,426,864**	2,359,889
Total expenses	**101,584,788**	91,872,205
Income before income taxes	**20,537,846**	32,876,584
Income taxes:		
Current	**3,860,494**	5,800,622
Deferred	**795,082**	(830,451)
	4,655,576	4,970,171
Net income	**$ 15,882,270**	$ 27,906,413

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Comprehensive Income

	Year Ended December 31	
	2012	**2011**
Net income	**$ 15,882,270**	$ 27,906,413
Other comprehensive income, net of tax:		
Unrealized gains on securities:		
Unrealized holding gains during the period	**1,104,248**	2,082,549
Less: reclassification adjustments for realized gains included in net income	**(674,765)**	(461,130)
Other comprehensive income	**429,483**	1,621,419
Total comprehensive income	**$ 16,311,753**	$ 29,527,832

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Shareholders' Equity

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total
Balance at January 1, 2011	$ 55	$ 24,408,268	$ 109,758,323	$ (10,000,000)	$ 4,349,705	$ 128,516,351
Dividends paid	–	–	(17,957,569)	–	–	(17,957,569)
Net income	–	–	27,906,413	–	–	27,906,413
Other comprehensive income, net of tax	–	–	–	–	1,621,419	1,621,419
Balance at December 31, 2011	55	24,408,268	119,707,167	(10,000,000)	5,971,124	140,086,614
Dividends paid	–	–	**(14,175,918)**	–	–	**(14,175,918)**
Net income	–	–	**15,882,270**	–	–	**15,882,270**
Other comprehensive income, net of tax	–	–	–	–	**429,483**	**429,483**
Balance at December 31, 2012	**$ 55**	**$ 24,408,268**	**$ 121,413,519**	**$ (10,000,000)**	**$ 6,400,607**	**$ 142,222,449**

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Cash Flows

	Year Ended December 31	
	2012	**2011**
Operating activities		
Net income	**$ 15,882,270**	$ 27,906,413
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**4,744,108**	5,626,624
Bad debt expense	**131,582**	–
Deferred income taxes	**795,082**	(830,451)
Realized net investment gains	**(1,309,092)**	(439,018)
Realized gains on equipment	**(120,592)**	(91,935)
Realized gain on sale of affiliate	**–**	(663,234)
Changes in:		
Restricted cash and investments	**(1,790,979)**	753,061
Accounts receivable from agents	**3,533,082**	(2,335,554)
Accounts receivable from insurance companies	**227,215**	(203,000)
Deferred acquisition costs	**2,934,314**	904,598
Reinsurance receivables	**(126,648,449)**	(139,840,407)
Income taxes receivable	**357,269**	257,544
Interest receivable	**116,998**	54,010
Premium taxes receivable	**(860,756)**	(595,771)
Other assets	**909,342**	(649,307)
Unpaid losses and loss adjustment expenses	**169,582,753**	99,834,606
Unearned premiums	**(40,286,243)**	36,377,924
Allowance for policy cancellations	**5,263,680**	(135,537)
Deferred ceding commissions	**(1,907,155)**	1,907,025
Accounts payable to agents	**(5,350,736)**	448,811
Accounts payable to insurance companies	**1,550,454**	(662,054)
Premium taxes payable	**(975,025)**	779,348
Other liabilities	**377,046**	1,765,233
Other payables, affiliate	**(97,201)**	126,624
Net cash provided by operating activities	**$ 27,058,967**	$ 30,295,553

State National Companies, Inc.

Consolidated Statements of Cash Flows (continued)

	Year Ended December 31	
	2012	**2011**
Investing activities		
Purchase of investments	**$ (53,256,168)**	$ (54,472,579)
Proceeds from sale of investments	**24,703,494**	16,947,024
Proceeds from maturities and principal receipts	**30,454,247**	21,252,762
Proceeds from sale of affiliate	**–**	663,234
Proceeds from dispositions of property and equipment	**506,862**	140,742
Purchase of property and equipment	**(1,885,162)**	(645,739)
Net cash provided by (used in) investing activities	**523,273**	(16,114,556)
Financing activities		
Dividends paid	**(14,175,918)**	(17,957,569)
Net cash used in financing activities	**(14,175,918)**	(17,957,569)
Net change in cash and cash equivalents	**13,406,322**	(3,776,572)
Cash and cash equivalents at beginning of year	**40,658,354**	44,434,926
Cash and cash equivalents at end of year	**$ 54,064,676**	$ 40,658,354
Supplemental disclosures of cash flow information		
Interest paid	**$ 2,381,946**	$ 2,313,814
Taxes paid	**$ 3,503,225**	$ 5,543,078

See accompanying notes.

1. Summary of Significant Accounting Policies

Description of Business

State National Companies, Inc. (the Company) refers to a group of companies that conduct insurance-related activities along two major lines of business. One line of business involves the writing and insuring of lines of insurance marketed to lending institutions, primarily collateral protection insurance (CPI) policies. A second line of business involves the writing of “program business,” which includes books of business produced by program managers, for which the Company receives ceding commissions. A majority of the risk associated with the program business is ceded to unaffiliated, highly rated reinsurance companies.

Principles of Consolidation

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

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP), which, as to our insurance company subsidiaries, differ from statutory accounting practices prescribed or permitted for insurance companies by insurance regulatory authorities.

Estimates

The preparation of financial statements in conformity with GAAP requires the Company’s management (Management) to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ materially from these estimates.

Cash and Cash Equivalents

All highly liquid investments with an original maturity of three months or less are considered cash equivalents. The carrying amounts reported in the consolidated balance sheets as cash and cash equivalents approximate fair value.

1. Summary of Significant Accounting Policies (continued)

Restricted Cash and Investments

Restricted cash and investments are primarily comprised of deposits made for a program that covers losses for this program up to the contractual threshold. These fiduciary cash and investment balances are invested at the direction of the reinsurer for this program; accordingly, income earned on these balances inures to the benefit of this reinsurer. The carrying amounts reported for restricted cash and investments in the consolidated balance sheets approximate fair value.

Investments

Investments are considered available-for-sale and are carried at fair value. The Company measures the fair value of the investments based upon quoted market prices from an independent pricing service and its third-party investment managers, using both observable and unobservable market information. The cost of securities sold is based on the specific identification method. Unrealized gains and losses associated with the available-for-sale portfolio, as a result of temporary changes in fair value during the period such investments are held, are reflected net of income taxes and reported in other comprehensive income as a separate component of shareholders' equity. Unrealized losses associated with the available-for-sale portfolio that are deemed to be other-than-temporary are charged to income in the period in which the other-than-temporary impairment is determined. Debt security premiums and discounts are amortized into earnings using the effective-interest method.

The Company evaluates its investment portfolio for impairments of individual securities that are deemed to be other-than-temporary. Fixed maturity securities that are determined to have other-than-temporary impairment and it is more likely than not the Company will sell before recovery of their amortized cost, are written down to fair value and the entire amount of the write-down is included in net income, net of realized investment gains. For all other impaired fixed-maturity securities, the impairment loss is separated into the amount representing the credit loss and the amount representing all other factors. The amount of impairment loss that represents the credit loss is included in net income, net of realized investment gains, and the amount of the impairment loss that relates to all other factors is included in other comprehensive income. Equity securities that are determined to have other-than-temporary impairment are recognized in net income, net of realized investment gains.

1. Summary of Significant Accounting Policies (continued)

The process for identifying other-than-temporary declines in fair value involves the consideration of several factors, including, but not limited to, whether the issuer has been downgraded to below investment-grade, the length of time in which there has been a significant decline in value, the liquidity and overall financial condition of the issuer, the nature and performance of the collateral or other credit support backing the security, the significance of the decline in value, and whether the Company has the intent to sell the security or may be required to sell the security prior to its anticipated recovery. The Company reviews securities for other-than-temporary impairment internally and with its investment advisors.

Deferred Acquisition Costs

Effective January 1, 2012, the Company adopted Accounting Standards Update (ASU) No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. The guidance identifies those costs relating to the successful acquisition of new or renewal insurance contracts that should be capitalized. The Company elected prospective application of this guidance (see Note 3 – "Deferred Acquisition Costs").

Certain costs, primarily premium taxes, commissions, and general expenses that are directly related to the successful acquisition of new or renewal business are deferred to the extent recoverable from future earned premiums. Deferred acquisition costs are amortized in proportion to the related unearned premium reserve over the terms of the related policies. Investment income is not included in the Company's recoverability analysis of deferred acquisition costs.

Ceding commissions that are in excess of the acquisition cost of the business ceded are established as a liability (deferred ceding commissions) and amortized into income pro rata over the life of the underlying business.

Property, Equipment, and Depreciation

Property and equipment are recorded at cost and depreciated. Depreciation is computed using the straight-line method over the estimated useful lives of the assets (ranging from two to twenty years). Gains and losses on the disposition of fixed assets are determined on a specific asset identification basis and are included in net income. Land held for sale is carried at fair value less expected selling costs.

1. Summary of Significant Accounting Policies (continued)

Goodwill and Intangible Assets

Goodwill is the difference between the purchase price in a business combination and the fair value of assets acquired and liabilities assumed, and is not amortized. Intangible assets include assets with a finite life, primarily customer relationships/lists, and are amortized over the estimated useful life of the asset in proportion to the expected benefit.

Goodwill is tested for impairment on an annual basis or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. The impairment test is performed using a two-step process. In the first step, the fair value of a reporting unit is compared to its carrying value. If the carrying value of a reporting unit exceeds its fair value, the second step of the impairment test is performed for purposes of measuring the impairment. In the second step, the fair value of the reporting unit is allocated to all of the assets and liabilities of the reporting unit to determine an implied goodwill value. If the carrying amount of the reporting unit goodwill exceeds the implied goodwill value, an impairment loss is recognized in an amount equal to that excess.

As of December 31, 2012, the Company performed the first step of its annual goodwill assessment for the individual reporting units to which goodwill is allocated and determined there is no impairment of goodwill.

The Company periodically evaluates the recoverability of intangible assets and takes into account events or circumstances that warrant revised estimates of useful lives or that indicate that an impairment exists. No impairments were recognized in 2012. However, the Company recognized an impairment charge of $451,801 in 2011 (see Note 5 – "Goodwill and Intangible Assets").

Unpaid Losses and Loss Adjustment Expenses

The liability for unpaid losses and loss adjustment expenses includes an estimate for claims reported and an additional liability for claims incurred but not reported, based on the Company's historical loss experience. While Management believes the amounts included in the consolidated financial statements are adequate, such estimates may be more or less than the amount ultimately paid when the claims are settled. These estimates are continually reviewed and adjusted, as necessary, as experience develops or as new information becomes known; such adjustments are included in current operations.

1. Summary of Significant Accounting Policies (continued)

Allowance for Policy Cancellations

An allowance for policy cancellations is provided for the estimated amount of return premiums and policy fees, net of commission expense and premium taxes that will be incurred on expected future policy cancellations associated with the Company's business. The allowance is based on the Company's historical cancellation experience.

While Management believes the amounts included in the consolidated financial statements are adequate, such estimates may be more or less than the amounts ultimately refunded. The estimates are continually reviewed by Management, and any changes are reflected in current operations.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts.

Income Taxes

Deferred income taxes are recorded on the Company's insurance subsidiaries, State National Insurance Company, Inc. (SNIC), National Specialty Insurance Company (NSIC), United Specialty Insurance Company (USIC), and State National Intermediate Holdings, Inc. (SNIH), SNIC's parent, to reflect the tax consequences on future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end. All other entities included in the consolidated group file under Subchapter S Corporation status; therefore, no provision for income taxes has been recorded for these entities.

For any uncertain tax positions not meeting the "more likely than not" recognition threshold, accounting standards require recognition, measurement, and disclosure in the financial statements. There were no uncertain tax positions at December 31, 2012 and 2011.

1. Summary of Significant Accounting Policies (continued)

Income Recognition

Premiums on CPI business are earned on a pro rata basis over the terms of the policies after taking into consideration the allowance for policy cancellations. Premiums on program business are earned on a pro rata basis over the terms of the policies. Ceding commissions are earned on the same basis as the underlying premiums.

Program Business

In connection with writing program business, the Company enters into contractual agreements with both the producing program managers and the reinsurers, whereby the program managers and reinsurers are obligated to each other for payment of insurance amounts, including premiums, commissions, and losses. These funds do not flow through the Company, but are settled directly between the program manager and the reinsurer; accordingly, no receivables or payables are recorded for these amounts. All obligations of SNIC, NSIC, and USIC owed to or on behalf of their policyholders are recorded by the Company and, to the extent appropriate, offsetting reinsurance receivables are recorded. Reinsurance receivables, agents' balances receivable and payable, and receivable from and payable to insurance companies reported in the consolidated balance sheets are carried at cost, which approximates fair value.

Treasury Stock

Treasury stock purchases are recorded under the cost method, whereby the entire cost of the acquired stock is recorded as treasury stock. Treasury stock will be reissued at the average purchase price per share of the aggregate treasury shares held.

Recently Issued Accounting Pronouncements Not Yet Adopted

In July 2012, the Financial Accounting Standards Board (FASB) issued an accounting update (ASU 2012-02) that adds an optional qualitative assessment for determining whether an indefinite-lived intangible asset is impaired. Companies have the option to first perform a qualitative assessment to determine whether it is more likely than not (a likelihood of more than 50%) that an indefinite-lived intangible asset is impaired. If a company determines that it is more likely than not that the fair value of such an asset exceeds its carrying amount, it would not need to calculate the fair value of the asset in that year. However, if a company concludes otherwise, it

1. Summary of Significant Accounting Policies (continued)

must perform the annual quantitative impairment test. The update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after September 15, 2012.

2. Investments

The following table summarizes information on the amortized cost, gross unrealized gains and losses, and the fair value of investment securities by class:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
Government	**$ 7,384,278**	**$ 360,548**	**$ (3,729)**	**$ 7,741,097**
Government agency	**2,875,230**	**124,274**	**(2,554)**	**2,996,950**
State and municipality	**31,960,441**	**1,738,916**	**–**	**33,699,357**
Industrial and miscellaneous	**46,159,402**	**3,349,810**	**(90,573)**	**49,418,639**
Residential mortgage-backed	**75,780,987**	**2,960,335**	**(295,824)**	**78,445,498**
Commercial mortgage-backed	**11,938,687**	**659,302**	**(220)**	**12,597,769**
Common stock	**36,328**	**252,443**	**(7,551)**	**281,220**
Preferred stock	**1,306,162**	**468,379**	**(12,046)**	**1,762,495**
	$177,441,515	**$ 9,914,007**	**$ (412,497)**	**$186,943,025**

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2011				
Government	$ 6,893,750	$ 477,241	$ –	$ 7,370,991
Government agency	2,697,612	142,773	–	2,840,385
State and municipality	37,277,759	2,329,000	(18,276)	39,588,483
Industrial and miscellaneous	43,288,774	2,374,909	(335,926)	45,327,757
Residential mortgage-backed	71,343,762	3,006,068	(313,834)	74,035,996
Commercial mortgage-backed	16,702,809	686,238	(502)	17,388,545
Common stock	36,327	201,232	(6,192)	231,367
Preferred stock	1,174,855	382,869	(67,012)	1,490,712
	$179,415,648	$ 9,600,330	$ (741,742)	$188,274,236

2. Investments (continued)

Investment securities are exposed to various risks such as interest rate, market, and credit risk. Fair values of securities fluctuate based on the magnitude of changing market conditions; significant changes in market conditions could materially affect the portfolio fair value in the near term.

The following tables show the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
December 31, 2012						
Government	**$ 985,420**	**$ (3,729)**	**$ –**	**$ –**	**$ 985,420**	**$ (3,729)**
Government agency	**623,409**	**(2,554)**	**–**	**–**	**623,409**	**(2,554)**
Industrial and miscellaneous	**2,885,145**	**(21,895)**	**1,118,460**	**(68,678)**	**4,003,605**	**(90,573)**
Residential mortgage-backed	**13,333,940**	**(161,004)**	**1,388,941**	**(134,820)**	**14,722,881**	**(295,824)**
Commercial mortgage-backed	**312,080**	**(220)**	**–**	**–**	**312,080**	**(220)**
Common stock	**–**	**–**	**16,803**	**(7,551)**	**16,803**	**(7,551)**
Preferred stock	**169,420**	**(1,242)**	**389,703**	**(10,804)**	**559,123**	**(12,046)**
	$ 18,309,414	**$ (190,644)**	**$ 2,913,907**	**$ (221,853)**	**$ 21,223,321**	**$ (412,497)**

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
December 31, 2011						
State and municipality	$ 249,288	$ (1,229)	$ 350,000	$ (17,047)	$ 599,288	$ (18,276)
Industrial and miscellaneous	7,669,589	(335,926)	–	–	7,669,589	(335,926)
Residential mortgage-backed	4,032,102	(34,713)	2,049,639	(279,121)	6,081,741	(313,834)
Commercial mortgage-backed	720,960	(502)	–	–	720,960	(502)
Common stock	18,162	(6,192)	–	–	18,162	(6,192)
Preferred stock	504,156	(67,012)	–	–	504,156	(67,012)
	$ 13,194,257	$ (445,574)	$ 2,399,639	$ (296,168)	$ 15,593,896	$ (741,742)

2. Investments (continued)

The determination that a security has incurred an other-than-temporary decline in fair value and the associated amount of any loss recognition requires the judgment of the Company's Management and a continual review of its investments. Management reviewed all securities with unrealized losses in accordance with the Company's impairment policy described in Note 1 – "Summary of Significant Accounting Policies." Management believes that the temporary impairments are primarily the result of interest rate fluctuations, current conditions in the capital markets, and the impact of those conditions on market liquidity and prices. There are 50 securities in an unrealized loss position at December 31, 2012. Over 88% of these investments are investment-grade at December 31, 2012. The Company does not intend to sell the securities, and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management has the intent and ability to hold the equity securities in an unrealized loss position until the recovery of their cost basis. Therefore, Management does not consider these investments to be other-than-temporarily impaired at December 31, 2012.

Proceeds from sales of investments in fixed-maturity and equity securities during 2012 and 2011 were $24,703,494 and $16,947,024, respectively.

The following table presents the Company's gross realized gains (losses) for the years ended December 31:

	2012	2011
Realized gains:		
Fixed-maturity securities	**$ 1,588,073**	$ 1,048,869
Equity securities	**38,059**	78,489
Gross realized gains	**1,626,132**	1,127,358
Realized losses:		
Fixed-maturity securities	**(99,001)**	(177,939)
Equity securities	**(41)**	–
Other-than-temporary impairment losses on fixed-maturity securities	**(217,998)**	(510,401)
Gross realized losses	**(317,040)**	(688,340)
Net realized investment gains	**$ 1,309,092**	$ 439,018

2. Investments (continued)

The following schedule details the maturities of the Company's fixed-maturity securities, available-for-sale, as of December 31, 2012:

	Amortized Cost	Fair Value
Due in one year or less	$ 6,628,649	$ 6,873,423
Due after one year through five years	48,979,642	51,801,638
Due after five years through ten years	27,063,420	29,122,241
Due after ten years	5,707,640	6,058,741
Residential mortgage-backed securities	75,780,987	78,445,498
Commercial mortgage-backed securities	11,938,687	12,597,769
	$ 176,099,025	$ 184,899,310

Expected maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

The Company's investment portfolio includes $1,540,919 of mortgage-backed securities collateralized by subprime residential loans, which represent approximately 0.82% of the Company's total investments as of December 31, 2012. The Company does not hold any mortgage derivatives.

Net investment income for the years ended December 31 consists of the following:

	2012	**2011**
Interest on investments	**$ 5,848,925**	$ 6,398,614
Dividends	**85,013**	87,096
Gross investment income	**5,933,938**	6,485,710
Investment expenses	**(408,871)**	(268,821)
Net investment income	**$ 5,525,067**	$ 6,216,889

SNIC, NSIC, and USIC are required to maintain deposits in various states where they are licensed to operate. These deposits are comprised of certificates of deposit and bonds at fair values totaling $22,839,571 and $17,649,223 at December 31, 2012 and 2011, respectively.

3. Deferred Acquisition Costs

Effective January 1, 2012, the Company prospectively adopted ASU No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts.* As a result of the adoption of this guidance, certain general and administrative costs that are not directly related to the successful acquisition of new or renewal business that were previously capitalized are no longer deferred. However, the Company continues to defer premium taxes, commissions and general expenses that are directly related to the successful acquisition of new or renewal business.

Deferred acquisition costs are as follows for the years ended December 31:

	2012	**2011**
Balance, beginning of year	**$ 4,110,647**	$ 5,015,245
Capitalized costs	**5,072,297**	21,783,942
Amortization	**(8,006,611)**	(22,688,540)
Balance, end of year	**$ 1,176,333**	$ 4,110,647

If the Company had applied the guidance per ASU 2010-26 during fiscal 2011, the deferred costs would have been reduced by $5,000,931 and amortization would have been reduced by $4,131,192 for a net reduction in deferred acquisition costs of $869,739. Due to the prospective application of the adoption of ASU 2010-26, this net reduction in deferred acquisition costs is reflected as a component of amortization expense for the year ended December 31, 2012.

4. Property, Equipment, and Depreciation

The following is a summary of property, equipment, and depreciation at December 31:

	2012	2011
Land held for use	**$ 3,473,119**	$ 2,405,763
Land held for sale	**1,034,000**	1,034,000
Building and improvements	**15,370,537**	15,370,537
Transportation equipment	**2,356,074**	2,658,334
Furniture and fixtures	**3,244,051**	3,238,494
Computer equipment and software	**5,187,453**	4,952,064
	30,665,234	29,659,192
Accumulated depreciation and amortization	**(10,206,390)**	(8,744,344)
Property and equipment, net	**$ 20,458,844**	$ 20,914,848
Depreciation and amortization expense	**$ 1,954,868**	$ 2,073,787

On November 28, 2007, the Company purchased a tract of land with a plan to build a new home office building for its own use. During 2009, the Company classified this land as held for sale, since it had abandoned its plan to build a new home office and purchased an existing building for its own use. Gains of $120,592 and $91,935 were recognized at December 31, 2012 and 2011, respectively, from the sale of equipment.

5. Goodwill and Intangible Assets

The following is a summary of goodwill and intangible assets:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
December 31, 2012			
Goodwill	**$ 2,565,390**	**$ –**	**$ 2,565,390**
Customer relationships/lists	**20,449,606**	**(14,713,477)**	**5,736,129**
Non-compete agreements	**3,338,790**	**(2,399,545)**	**939,245**
	$ 26,353,786	**$ (17,113,022)**	**$ 9,240,764**
December 31, 2011			
Goodwill	$ 2,565,390	$ –	$ 2,565,390
Customer relationships/lists	20,449,606	(13,810,507)	6,639,099
Non-compete agreement	3,338,790	(1,894,955)	1,443,835
	$ 26,353,786	$ (15,705,462)	$ 10,648,324

Amortization expense related to the customer relationships/lists was $902,970 and $1,062,828 for the years ended December 31, 2012 and 2011, respectively. The non-compete agreements are amortized based on discounted cash flow estimates over their expected useful lives of five to nine years. Amortization expense related to the non-compete agreements was $504,590 and $910,447 for the years ended December 31, 2012 and 2011, respectively. During 2011, the Company recorded an impairment of $451,801 on one of the non-compete agreements, which is included as a component of general and administrative expenses in the 2011 consolidated statement of income. The Company used the present value of estimated future cash flows in determining the amount of impairment. No such impairment was recognized in 2012.

Expected amortization expense over the next five years for the Company's customer relationships/lists and non-compete agreements is as follows: 2013 – $1,334,834; 2014 – $1,244,577; 2015 – $745,673; 2016 – $707,470; and 2017 – $660,938.

6. Subordinated Debentures

Between 2002 and 2004, the Company formed four business trusts (the Trusts) for the sole purpose of issuing, in private placement transactions, $52 million of trust preferred securities (TPS). In turn, the Trusts then used the proceeds thereof, together with the equity proceeds received from the Company upon their initial formation, to purchase $53.6 million of variable-rate subordinated debentures (TPS Debentures) issued by the Company. All voting securities of the Trusts are owned by the Company, and the TPS Debentures are the sole assets of the Trusts. The Trusts meet the obligations of the TPS with the interest and principal paid on the TPS Debentures. The Company does not have a variable interest in the Trusts and therefore does not consolidate the Trusts.

The following is a summary of the TPS Debentures at December 31:

	2012	2011
Floating Rate Capital Securities at LIBOR plus 4.00%, issued December 4, 2002, maturing on December 4, 2032	**$ 17,500,000**	$ 17,500,000
Floating Rate Capital Securities at LIBOR plus 4.10%, issued May 15, 2003, maturing on May 15, 2033	**7,500,000**	7,500,000
Floating Rate Capital Securities at LIBOR plus 4.10%, issued December 16, 2003, maturing on January 8, 2034	**12,000,000**	12,000,000
Floating Rate Capital Securities at LIBOR plus 3.80%, issued May 26, 2004, maturing on May 24, 2034	**15,000,000**	15,000,000
	$ 52,000,000	$ 52,000,000

The TPS Debentures and the TPS are uncollateralized, do not require maintenance of minimum financial covenants, and carry nearly identical terms. The TPS mature based on the schedule above, but early redemption is allowed beginning five years after issue date. If the Company chooses to redeem before the stated maturity date, it must redeem on a normal quarterly interest payment date and in multiples of $1,000 (and include accrued interest).

Interest is payable quarterly (see rates above) and set and paid quarterly. The three-month LIBOR rate at December 31, 2012 was 0.31%. Payment of interest may be deferred for up to 20 consecutive quarters; however, the Company may not declare or pay any dividends or distributions, nor make any guarantee payments or payments on fixed-maturity securities, unless senior in interest to the TPS Debentures. These same limitations apply during an event of default.

6. Subordinated Debentures (continued)

Debt issuance costs paid to placement agents with an initial cost of $1,514,250 are included in the consolidated financial statements in other assets (net of accumulated amortization of $472,368 and $421,893 at December 31, 2012 and 2011, respectively) and are being amortized over 30 years using the straight-line method, which approximates the effective interest method.

The Company has guaranteed that amounts paid to the Trusts under the TPS Debentures will be remitted to the holders of the TPS. These guarantees, when taken together with the obligations of the Company under the TPS Debentures, the indentures pursuant to which those debentures were issued, and the related trust agreements (including obligations to pay related trust costs, fees, expenses, debt, and other obligations for the Trusts other than with respect to the common and trust preferred securities of the Trusts), provide a full and unconditional guarantee of amounts due on the TPS.

The amounts reported in the consolidated balance sheets are carried at par, which approximates their estimated fair value due to the floating interest rate provisions of the debt instruments.

7. Income Tax Provision

The shareholders consented to elections for certain entities in the Company to be treated as S Corporations under Internal Revenue Code Section 1362(a). As a result of the elections, 2012 federal income taxes are recorded only for SNIH, SNIC, NSIC, and USIC, as they remain C Corporations. Income for the Company's pass-through entities is taxed (for federal purposes) to the individual owners.

The components of income tax expense for the years ended December 31 are as follows:

2012	**Federal**	**State**	**Total**
Federal and state income tax expense			
Current	$ 3,194,623	$ 665,871	$ 3,860,494
Deferred	795,082	–	795,082
Total income tax expense	$ 3,989,705	$ 665,871	$ 4,655,576

7. Income Tax Provision (continued)

2011	**Federal**	**State**	**Total**
Federal and state income tax expense			
Current	$ 4,998,589	$ 802,033	$ 5,800,622
Deferred	(830,451)	–	(830,451)
Total income tax expense	$ 4,168,138	$ 802,033	$ 4,970,171

Deferred income taxes reflect the effect of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. The components of the net deferred income tax asset are as follows at December 31:

	2012	**2011**
Deferred income tax assets:		
Allowance for policy cancellations	**$ 4,922,861**	$ 5,251,587
Unpaid losses and loss adjustment expenses	**260,919**	201,158
Deferred ceding commissions	**4,102,842**	4,756,997
Management fee	**3,392,683**	1,555,602
Write-down of other-than-temporarily impaired investment securities	**569,758**	529,858
Other	**55,694**	55,694
Total deferred income tax assets	**13,304,757**	12,350,896
Deferred income tax liabilities:		
Unearned premiums	**3,542,404**	3,070,034
Unrealized gains on investment securities	**3,224,499**	3,034,154
Deferred acquisition costs	**3,869,492**	2,751,666
Contingent commissions	**2,949,301**	2,671,293
Other	**252,294**	348,460
Total deferred income tax liabilities	**13,837,990**	11,875,607
Net deferred income tax (liability) asset	**$ (533,233)**	$ 475,289

7. Income Tax Provision (continued)

The Company computes its income tax provision using a 34.3% tax rate as its taxable income is within the graduated rates of 34% to 35%. A reconciliation of federal income tax expense computed by applying the federal income tax rate of 34.3% to income before federal income tax expense for the years ended December 31 is as follows:

	2012		**2011**	
	Amount	**Effective Tax Rate**	**Amount**	**Effective Tax Rate**
Expected tax expense	**$ 7,044,481**	**34.3%**	$ 11,276,668	34.3%
Exclusion of Subchapter S status	**(2,799,801)**	**(13.6)**	(6,505,681)	(19.8)
Tax-exempt income	**(246,678)**	**(1.2)**	(311,124)	(0.9)
State income taxes	**619,591**	**3.0**	731,000	2.2
Other	**37,983**	**0.2**	(220,692)	(0.7)
Total income tax expense	**$ 4,655,576**	**22.7%**	$ 4,970,171	15.1%

The Company fully utilized a charitable contribution carryforward in 2011 of $111,124 that would have expired in 2013.

The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expenses. There were no penalties or interest recognized during 2012 or 2011. As of December 31, 2012, the Company's U.S. federal income tax returns for tax years that ended December 31, 2009 through December 31, 2011, remain open under the normal three year statute of limitations and, therefore, are subject to examination by the Internal Revenue Service.

8. Reinsurance

Through unaffiliated Program Managers, SNIC, NSIC, and USIC write primarily auto and commercial lines of business. This business is written pursuant to quota share and excess of loss reinsurance contracts and general agency agreements that are tripartite agreements executed by SNIC, NSIC, or USIC, the reinsurer, and the general agent. Substantially all of the risk associated with this business is borne by the reinsurer.

8. Reinsurance (continued)

As compensation for writing this business, SNIC, NSIC, and USIC receive ceding commissions from the program managers and, accordingly, the related ceding commissions receivable are reflected as accounts receivable from agents. If the program manager defaults on its obligation to pay these commissions (or any other amount due), the reinsurer is obligated to make the payment under the guarantee contained in the contracts. In addition, the Company is party to a reinsurance agreement in which it cedes 50% of certain CPI policies to CUMIS Insurance Society, Inc. (CUNA) and receives a ceding commission related to these policies (see Note 18 – "Commitments and Contingencies"). The Company retains 50% of the risk related to these policies.

SNIC, NSIC, and USIC remain liable for unearned premiums and unpaid losses and loss adjustment expenses with respect to reinsurance ceded should the reinsurer be unable to meet its obligations. Management considers the possibility of a reinsurer becoming unable to meet its obligations as remote due to the reinsurers' financial stability, A.M. Best Company rating, size, security funds available, and other factors as appropriate. Following is a summary of these balances at December 31:

	2012	**2011**
Ceded unearned premiums	**$ 235,087,397**	$ 276,443,005
Ceded loss and loss adjustment expense reserves	**965,965,189**	797,961,132
Total reinsurance receivables	**1,201,052,586**	1,074,404,137
Secured balances	**(851,044,731)**	(590,609,503)
Unsecured reinsurance receivables	**$ 350,007,855**	$ 483,794,634

SNIC, NSIC, and USIC hold collateral securing $851,044,731 of ceded balances at December 31, 2012. The fair value of the collateral is approximately 139% of the related receivables as of December 31, 2012.

9. Fair Value Measurements

Assets and liabilities reported in the consolidated financial statements at fair value are required to be classified according to a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into three levels. The hierarchy gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities

9. Fair Value Measurements (continued)

(Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Level 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

- Level 1: Inputs are quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date.

- Level 2: Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices from those willing to trade in markets that are not active, or other inputs that are observable or can be corroborated by market data for the term of the instrument. These inputs include market interest rates and volatilities, spreads, and yield curves.

- Level 3: Inputs are unobservable. Unobservable inputs reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

A description of the Company's valuation techniques used to measure its assets at fair value is as follows:

- Available-for-sale, fixed-maturity securities: All fixed-maturity investments are currently reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from either an independent pricing service using quoted prices or from its third-party investment managers. These Level 2 inputs are valued by either the pricing service or the investment managers utilizing observable data that may include dealer quotes, market spreads, cash flows, yield curves, live trading levels, trade execution data, market consensus, prepayment speeds, credit information, and the security's terms and conditions, among other things. Management has reviewed the processes used by the pricing services and has determined that they result in fair values consistent with requirements of ASC 820 for Level 2 investment securities.

  During 2011, three fixed-maturity securities were reported at fair value utilizing Level 3 inputs. These securities were priced by the investment managers utilizing cash flow analyses with unobservable inputs.

9. Fair Value Measurements (continued)

- Available-for-sale equity securities: Equity securities are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service using quoted prices or from its third-party investment managers.

Based on an analysis of the inputs, the Company's investments measured at fair value on a recurring basis at December 31 have been categorized as follows:

	Level 1	Level 2	Level 3	2012
Investments				
Fixed-maturity securities (available-for-sale):				
Government	**$ –**	**$ 7,741,097**	**$ –**	**$ 7,741,097**
Government agency	**–**	**2,996,950**	**–**	**2,996,950**
State and municipality	**–**	**33,699,357**	**–**	**33,699,357**
Industrial and miscellaneous	**–**	**49,418,639**	**–**	**49,418,639**
Residential mortgage-backed	**–**	**78,445,498**	**–**	**78,445,498**
Commercial mortgage-backed	**–**	**12,597,769**	**–**	**12,597,769**
Equity securities (available-for-sale)	**–**	**2,043,715**	**–**	**2,043,715**
	$ –	**$ 186,943,025**	**$ –**	**$ 186,943,025**

	Level 1	Level 2	Level 3	2011
Investments				
Fixed-maturity securities (available-for-sale):				
Government	$ –	$ 7,370,991	$ –	$ 7,370,991
Government agency	–	2,840,385	–	2,840,385
State and municipality	–	39,588,483	–	39,588,483
Industrial and miscellaneous	–	45,327,757	–	45,327,757
Residential mortgage-backed	–	73,224,664	811,332	74,035,996
Commercial mortgage-backed	–	17,388,545	–	17,388,545
Equity securities (available-for-sale)	–	1,722,079	–	1,722,079
	$ –	$ 187,462,904	$ 811,332	$ 188,274,236

9. Fair Value Measurements (continued)

A reconciliation of the beginning and ending balances for the fixed maturity securities categorized as Level 3 during the years ended December 31 is as follows:

	2012	2011
Beginning balance, January 1	**$ 811,332**	$ 1,067,390
Total gains or losses:		
Included in realized net investment gains	**(147,776)**	(244,503)
Included in other comprehensive income	**(51,793)**	22,661
Purchases and issuances	**–**	–
Sales and settlements	**–**	–
Transfers out of Level 3	**(611,763)**	(34,216)
Ending balance, December 31	**$ –**	$ 811,332

Transfers between levels are recognized at the end of the reporting period. The securities transferred out of Level 3 were transferred into Level 2. In the prior year, these securities were priced using Level 3 inputs, as third-party pricing was not reflective of a liquid market, but rather reflected a potential sale in a distressed market. In 2012, third-party pricing of the transferred securities was more reflective of the value of the securities in a liquid rather than a distressed market.

There were no transfers between Level 1 and Level 2.

10. Premiums Earned

Premiums earned consist of the following for the years ended December 31:

	2012	2011
Premiums written	**$633,108,994**	$711,188,332
Premiums assumed	**1,711,838**	1,646,181
Premiums ceded	**(555,655,375)**	(632,531,332)
Net premiums retained	**79,165,457**	80,303,181
Change in net unearned premiums	**(1,069,365)**	1,671,204
Total premiums earned	**$ 78,096,092**	$ 81,974,385

10. Premiums Earned (continued)

Premiums written for CPI include an allowance for return premiums and policy fees related to expected future policy cancellations. Original estimates are adjusted as the policies develop and additional information becomes known regarding actual cancellation rates.

11. Losses and Loss Adjustment Expenses

Losses and loss adjustment expenses consist of the following for the years ended December 31:

	2012	2011
Direct losses and loss adjustment expenses	**$729,137,530**	$588,644,386
Assumed losses and loss adjustment expenses	**6,521,258**	600,310
Ceded losses and loss adjustment expenses	**(706,669,935)**	(559,612,549)
Total net losses and loss adjustment expenses	**$ 28,988,853**	$ 29,632,147

Activity in the liability for unpaid losses and loss adjustment expenses at December 31 is summarized as follows:

	2012	2011
Balance at January 1	**$ 806,125,401**	$ 706,290,795
Reinsurance receivables	**(797,961,132)**	(696,169,853)
Net balance at January 1	**8,164,269**	10,120,942
Incurred related to:		
Current year	**28,893,617**	32,284,841
Prior year	**95,236**	(2,652,694)
Total incurred	**28,988,853**	29,632,147
Paid related to:		
Current year	**23,392,459**	26,834,489
Prior year	**4,017,698**	4,754,331
Total paid	**27,410,157**	31,588,820
Net balance at December 31	**9,742,965**	8,164,269
Reinsurance receivables	**965,965,189**	797,961,132
Balance at December 31	**$ 975,708,154**	$ 806,125,401

11. Losses and Loss Adjustment Expenses (continued)

The estimate for ultimate losses incurred related to prior years increased by $95,236 and decreased by $2,652,694 in 2012 and 2011, respectively, primarily as a result of re-estimation of unpaid losses and loss adjustment expenses, principally on general liability, commercial auto, commercial multi peril, and credit lines of insurance in 2012 and commercial auto, commercial multi-peril, and credit lines of insurance in 2011. The net changes in 2012 and 2011 are the result of ongoing analysis of recent loss development trends. Original estimates are adjusted as additional information becomes known regarding individual claims.

12. Statutory Accounting

A reconciliation of the Company's insurance subsidiaries' (SNIC, NSIC, and USIC) shareholders' equity and net income as of and for the years ended December 31 from Statutory Accounting Principles (SAP) to GAAP is as follows:

	2012	2011
Shareholders' equity (insurance subsidiaries only):		
Per statutory basis	**$ 147,808,982**	$ 140,708,366
Adjustments for:		
Allowance for return commissions	**17,288,045**	13,414,175
Allowance for policy cancellations	**(14,093,124)**	(13,166,445)
Commissions payable	**8,723,095**	7,788,027
Deferred acquisition costs	**11,281,316**	8,022,349
Deferred income taxes	**(7,785,943)**	(6,972,187)
Unrealized gain on investments available-for-sale	**9,176,275**	8,561,484
Management fees	**(9,891,204)**	(4,535,284)
Intangible assets	**1,947,092**	1,947,092
Nonadmitted assets	**33,055**	30,453
Other	**182,084**	212,317
Shareholders' equity in accordance with GAAP	**$ 164,669,673**	$ 156,010,347

12. Statutory Accounting (continued)

	2012	2011
Net income (insurance subsidiaries only):		
Per statutory basis	**$ 7,290,498**	$ 8,745,667
Adjustments for:		
Allowance for return commissions	**3,873,870**	(203,981)
Allowance for policy cancellations	**(926,679)**	384,087
Commission expense	**935,068**	83,711
Deferred acquisition costs	**3,258,967**	(692,998)
Deferred income taxes	**(795,082)**	830,451
Management fees	**(5,355,920)**	321,885
Other	**(30,231)**	68,885
Net income in accordance with GAAP	**$ 8,250,491**	$ 9,537,707

At December 31, 2012 and 2011, the amount of statutory capital and surplus for the consolidated insurance subsidiaries was $147,808,982 and $140,708,366, respectively. At December 31, 2012 and 2011, minimum statutory capital and surplus required for SNIC, NSIC, and USIC was $2,000,000, $2,000,000, and $750,000, respectively. The Texas Department of Insurance (the Department) requires approval for dividends from insurance subsidiaries that exceed statutory guidelines. The maximum dividend that may be paid without prior approval of the Commissioner of Insurance is limited to the greater of 10% of statutory surplus at the end of the preceding calendar year or the statutory net income of the preceding calendar year. At December 31, 2012, unrestricted net assets available for dividends were $14,780,898.

The Company is required to comply with the NAIC's Risk-Based Capital (RBC) requirements. Under the RBC standards, risks specific to the Company in such areas as asset risk, insurance risk, interest rate risk, and business risk are evaluated and compared to the Company's capital and surplus to determine solvency margins. In its calculation of risk-based capital for SNIC and NSIC, the Company has deducted amounts for which it holds collateral (either trust funds in the name of the Company or irrevocable letters of credit) for amounts recoverable from reinsurance companies. The Company believes this practice to be appropriate because the credit risk for the related reinsurance balances is virtually eliminated due to the protection provided by the collateral. This practice differs from NAIC annual statement instructions. There is no monetary effect on net income or statutory surplus from the use of this practice. If the Company had not used this practice, the SNIC RBC calculation would not have resulted in a regulatory event in 2012 or 2011. If the Company had not used this practice in the NSIC RBC calculation, a regulatory event would not have resulted in 2012 but would have resulted in 2011.

12. Statutory Accounting (continued)

At periodic intervals, the Department routinely examines the insurance subsidiaries' statutory financial statements as part of its legally prescribed oversight of the insurance industry. Based on these examinations, regulators can direct that the statutory-basis financial statements be adjusted in accordance with their findings. The Texas Department of Insurance completed its examination of the December 31, 2006 through December 31, 2010 statutory-basis financial statements of NSIC and SNIC in 2012, with no significant findings reported. The Delaware Insurance Department also completed its examination of the December 31, 2006 through December 31, 2010 statutory-basis financial statements of USIC in 2012, with no significant findings reported.

13. Related-Party Transactions

The accompanying consolidated financial statements include other payables to an affiliate, Trace Air, Inc., in the amounts of $138,423 and $235,624 as of December 31, 2012 and 2011, respectively.

On June 5, 2009, the Company sold 100% of the issued and outstanding shares of CYR Insurance Management Company to American Hallmark Insurance Company of Texas, an unaffiliated third party (the Sale Transaction). In connection with the Sale Transaction, the Company recognized zero and $663,234 of contingent consideration in 2012 and 2011, respectively.

14. Comprehensive Income

Total comprehensive income for the year ended 2012 is reported in the Company's consolidated statements of shareholders' equity. Total accumulated other comprehensive income is reported in the Company's consolidated balance sheets. Total accumulated other comprehensive income was $6,400,607 and $5,971,124 as of December 31, 2012 and 2011, respectively, and solely comprised of unrealized gains and losses on available-for-sale securities, net of federal income taxes.

14. Comprehensive Income (continued)

The components of other comprehensive income are as follows:

	Gross Amount	Tax Effect	Net Amount
December 31, 2012			
Unrealized gains arising during the period	**$ 1,646,049**	**$ 541,801**	**$ 1,104,248**
Reclassification for securities sold or impaired during the period	**(1,003,126)**	**(328,361)**	**(674,765)**
Net unrealized gains arising during the period	**642,923**	**213,440**	**429,483**
Other comprehensive income	**$ 642,923**	**$ 213,440**	**$ 429,483**

	Gross Amount	Tax Effect	Net Amount
December 31, 2011			
Unrealized gains arising during the period	$ 3,131,479	$ 1,048,930	$ 2,082,549
Reclassification for securities sold or impaired during the period	(692,577)	(231,447)	(461,130)
Net unrealized gains arising during the period	2,438,902	817,483	1,621,419
Other comprehensive income	$ 2,438,902	$ 817,483	$ 1,621,419

15. 401(k) Profit-Sharing Plan and Trust

The Company has a 401(k) profit-sharing plan for employees that covers substantially all officers and employees who are at least 18 years of age. The Company is required to make a matching contribution of 50% of employees' contributions, limited to 6% of eligible employees' compensation. Also, the Company may make additional matching and profit-sharing contributions that are discretionary and are determined at the end of each plan year. The employer contribution expense included in general and administrative expenses is $936,935 and $1,005,627 for the years ended December 31, 2012 and 2011, respectively.

16. Concentration of Risk

The Company maintains cash and cash equivalents in accounts with financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. The Company monitors the financial stability of these institutions regularly, and Management does not believe there is significant credit risk associated with deposits in excess of federally insured amounts.

16. Concentration of Risk (continued)

A significant portion of the Company's writings occur in California, Texas, New York, Florida, and New Jersey. Eight customers comprised approximately 19% of the Company's CPI writings. Three reinsurers represent 57% of the Company's unsecured ceded balances.

17. Leases

The Company leases a portion of its home office building to an unaffiliated third party under the terms of an operating lease. Rental income for the years ended December 31, 2012 and 2011 is $1,291,254 and $1,346,254, respectively. Future minimum lease payments associated with the lease are as follows: 2013 – $1,289,242; 2014 – $1,295,382; 2015 – $1,362,914; 2016 – $1,362,914 and 2017 – $1,393,610.

18. Commitments and Contingencies

The Company is involved in various legal proceedings incidental to its normal business activities. Management of the Company does not anticipate that the outcome of such legal actions will have a material effect on the Company's consolidated financial position or results of operations.

SNIC, NSIC, and USIC are subject to assessments from various insurance regulatory agencies related to insurance company insolvencies. Management is not aware of any material assessments for which notice has not yet been received. However, to the extent that such assessments are made, the Company has the contractual right to recover these amounts from the underlying reinsurers.

In July 2009, the Company formed a Collateral Protection Alliance (the Alliance) with CUMIS Insurance Society, Inc., a subsidiary of CUNA, to administer and write CPI business for their customers. The Alliance includes an agency agreement and a reinsurance agreement whereby the Company cedes 50% of the business back to CUNA. The Company did not account for the Alliance as a business combination because it did not result in a change of control. In connection with the Alliance, the Company has a purchase option and CUNA has a put option, whereby the Company is obligated to purchase CUNA's right to participate in future program business in the event of termination of the Alliance at a specified price.

19. Subsequent Events

The Company has evaluated subsequent events from the balance sheet date through March 29, 2013, which is the date the consolidated financial statements were available to be issued.

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