Consolidated Financial Statements

State National Companies, Inc.
Years Ended December 31, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

Ernst & Young

State National Companies, Inc.

Consolidated Financial Statements

Years Ended December 31, 2011 and 2010

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 balance sheets of State National Companies, Inc. as of December 31, 2011 and 2010, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended. 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 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 financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of State National Companies, Inc. at December 31, 2011 and 2010, 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 30, 2012

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State National Companies, Inc.

Consolidated Balance Sheets

	December 31 2011	2010
Assets		
Investments:		
Fixed-maturity securities – available-for-sale, at fair value (amortized cost: 2011 – $178,204,466; 2010 – $163,008,321)	**$ 186,552,157**	$ 168,778,137
Equity securities – available-for-sale, at fair value (cost: 2011 – $1,211,182; 2010 – $823,279)	**1,722,079**	1,473,148
Total investments	**188,274,236**	170,251,285
Cash and cash equivalents	**40,658,354**	44,434,926
Restricted cash and investments	**6,279,717**	7,032,778
Accounts receivable from agents, net	**12,584,131**	10,248,577
Accounts receivable from insurance companies	**1,238,861**	1,035,861
Deferred acquisition costs	**4,110,647**	5,015,245
Reinsurance receivables	**1,074,404,137**	934,563,730
Property and equipment, net	**20,914,848**	22,391,702
Interest receivable	**1,380,748**	1,434,758
Premium taxes receivable	**1,476,090**	880,319
Income taxes receivable	**68,242**	325,786
Deferred income taxes, net	**475,289**	462,320
Goodwill and intangible assets, net	**10,648,324**	13,073,401
Other assets	**3,898,459**	3,249,152
Total assets	**$ 1,366,412,083**	$ 1,214,399,840

State National Companies, Inc.

Consolidated Balance Sheets (continued)

	December 31	
	2011	**2010**
Liabilities		
Unpaid losses and loss adjustment expenses	**$ 806,125,401**	$ 706,290,795
Unearned premiums	**293,924,236**	257,546,312
Allowance for policy cancellations	**27,510,893**	27,646,430
Deferred ceding commissions	**13,868,795**	11,961,770
Accounts payable to agents	**7,414,799**	6,965,988
Accounts payable to insurance companies	**2,525,241**	3,187,295
Subordinated debentures	**52,000,000**	52,000,000
Premium taxes payable	**3,742,650**	2,963,302
Other liabilities	**18,977,830**	17,212,597
Other payables, affiliate	**235,624**	109,000
Total liabilities	**1,226,325,469**	1,085,883,489
Commitments and contingencies *(Note 18)*	**–**	–
Shareholders' equity		
Common stock, $.001 par value (100,000 shares authorized, 55,200 shares issued, of which 8,764 are being held as treasury stock)	**55**	55
Additional paid-in capital	**24,408,268**	24,408,268
Retained earnings	**119,707,167**	109,758,323
Less treasury stock (8,764 shares at cost)	**(10,000,000)**	(10,000,000)
Accumulated other comprehensive income	**5,971,124**	4,349,705
Total shareholders' equity	**140,086,614**	128,516,351
Total liabilities and shareholders' equity	**$ 1,366,412,083**	$ 1,214,399,840

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Income

	Year Ended December 31	
	2011	**2010**
Revenues:		
Premiums earned	**$ 81,974,385**	$ 90,244,278
Commission income	**2,246,723**	1,778,184
Ceding commissions	**30,454,770**	31,009,548
Net investment income	**6,216,889**	6,567,419
Realized gains on sale of equipment	**91,935**	38,969
Realized gain on sale of affiliate	**663,234**	586,766
Realized net investment gains	**439,018**	501,014
Other income	**2,661,835**	1,862,717
Total revenues	**124,748,789**	132,588,895
Expenses:		
Losses and loss adjustment expenses	**29,632,147**	33,330,576
Commissions	**4,351,649**	5,328,163
Taxes, licenses, and fees	**2,245,151**	2,172,177
General and administrative	**53,283,369**	57,967,112
Interest expense	**2,359,889**	2,360,148
Total expenses	**91,872,205**	101,158,176
Income before income taxes	**32,876,584**	31,430,719
Income taxes:		
Current	**5,800,622**	4,129,102
Deferred	**(830,451)**	1,261,656
	4,970,171	5,390,758
Net income	**$ 27,906,413**	$ 26,039,961

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, 2010	$ 55	$ 24,408,268	$ 91,419,817	$ (10,000,000)	$ 2,721,089	$ 108,549,229
Dividends paid	–	–	(7,701,455)	–	–	(7,701,455)
Comprehensive income:						
Net income	–	–	26,039,961	–	–	26,039,961
Other comprehensive loss, net of tax	–	–	–	–	1,628,616	1,628,616
Total comprehensive income	–	–	26,039,961	–	1,628,616	27,668,577
Balance at December 31, 2010	55	24,408,268	109,758,323	(10,000,000)	4,349,705	128,516,351
Dividends paid	–	–	**(17,957,569)**	–	–	**(17,957,569)**
Comprehensive income:						
Net income	–	–	**27,906,413**	–	–	**27,906,413**
Other comprehensive income, net of tax	–	–	–	–	**1,621,419**	**1,621,419**
Total comprehensive income	–	–	**27,906,413**	–	**1,621,419**	**29,527,832**
Balance at December 31, 2011	**$ 55**	**$ 24,408,268**	**$ 119,707,167**	**$ (10,000,000)**	**$ 5,971,124**	**$ 140,086,614**

See accompanying notes.

State National Companies, Inc.

Consolidated Statements of Cash Flows

	Year Ended December 31	
	2011	**2010**
Operating activities		
Net income	**$ 27,906,413**	$ 26,039,961
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**5,626,624**	4,293,534
Deferred income taxes	**(830,451)**	1,261,656
Realized net investment gains	**(439,018)**	(501,014)
Realized gains on equipment	**(91,935)**	(38,969)
Realized gain on sale of affiliate	**(663,234)**	(586,766)
Changes in:		
Restricted cash and investments	**753,061**	(2,337,175)
Accounts receivable from agents	**(2,335,554)**	2,556,363
Accounts receivable from insurance companies	**(203,000)**	(884,291)
Deferred acquisition costs	**904,598**	366,414
Reinsurance receivables	**(139,840,407)**	(125,447,451)
Income taxes receivable	**257,544**	(437,315)
Interest receivable	**54,010**	(225,633)
Premium taxes receivable	**(595,771)**	(18,517)
Other assets	**(649,307)**	(32,075)
Unpaid losses and loss adjustment expenses	**99,834,606**	117,800,972
Unearned premiums	**36,377,924**	2,605,670
Allowance for policy cancellations	**(135,537)**	3,350,499
Deferred ceding commissions	**1,907,025**	(409,977)
Accounts payable to agents	**448,811**	2,615,988
Accounts payable to insurance companies	**(662,054)**	(710,926)
Premium taxes payable	**779,348**	(980,822)
Other liabilities	**1,765,233**	6,239,373
Other payables, affiliate	**126,624**	(55,518)
Net cash provided by operating activities	**$ 30,295,553**	$ 34,463,981

State National Companies, Inc.

Consolidated Statements of Cash Flows (continued)

	Year Ended December 31	
	2011	**2010**
Investing activities		
Purchase of investments	**$ (54,472,579)**	$ (52,642,881)
Proceeds from sale of investments	**16,947,024**	14,839,784
Proceeds from maturities and principal receipts	**21,252,762**	16,966,734
Proceeds from sale of affiliate	**663,234**	586,766
Proceeds from dispositions of property and equipment	**140,742**	156,530
Purchase of property and equipment	**(645,739)**	(2,437,654)
Purchase of Finegold Insurance Associates, Inc.	**–**	(8,000,000)
Net cash used in investing activities	**(16,114,556)**	(30,530,721)
Financing activities		
Dividends paid	**(17,957,569)**	(7,701,455)
Net cash used in financing activities	**(17,957,569)**	(7,701,455)
Net change in cash and cash equivalents	**(3,776,572)**	(3,768,195)
Cash and cash equivalents at beginning of year	**44,434,926**	48,203,121
Cash and cash equivalents at end of year	**$ 40,658,354**	$ 44,434,926
Supplemental disclosures of cash flow information		
Interest paid	**$ 2,313,814**	$ 2,299,627
Taxes paid	**$ 5,543,078**	$ 4,566,418

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 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)

In general, 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

The costs associated with the acquisition of new business (including commissions to unrelated parties, premium taxes, other costs of sales, and other agency expenses that vary directly with the production of new 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. The accounting for deferred acquisition costs will change due to revised accounting guidance that will become effective January 1, 2012. See "Recently Issued Accounting Pronouncements Not Yet Adopted."

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.

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.

1. Summary of Significant Accounting Policies (continued)

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, 2011, 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. The Company recognized an impairment charge of $451,801 and zero in 2011 and 2010, respectively (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.

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.

1. Summary of Significant Accounting Policies (continued)

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, 2011 and 2010.

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.

1. Summary of Significant Accounting Policies (continued)

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 October 2010, the FASB issued new guidance related to the 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. This guidance is effective for the year beginning January 1, 2012, and may be applied prospectively or retrospectively. The amount of acquisition costs the Company will defer under the revised guidance will be less than the amount deferred under current accounting practice.

In September 2011, the FASB issued an accounting update to simplify how entities test goodwill for impairment. Under the update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The update permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the current two-step goodwill impairment test. The update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011.

1. Summary of Significant Accounting Policies (continued)

In 2011, the FASB issued amendments to the presentation of other comprehensive income. The amendments provide the option to present other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The components of other comprehensive income have not changed, nor has the guidance on when other comprehensive income items are reclassified to net income. All reclassification adjustments from other comprehensive income to net income are required to be presented on the face of the financial statements or disclosed in the notes to the financial statements. The amendments are effective for fiscal years ending after December 15, 2012. The Company does not anticipate this amendment will have a material impact on its financial position or results of operations, but will impact financial statement presentation.

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, 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)

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2010				
Government	$ 6,974,163	$ 369,586	$ (13,333)	$ 7,330,416
Government agency	3,677,471	132,462	(23,598)	3,786,335
State and municipality	35,805,270	1,282,449	(179,293)	36,908,426
Industrial and miscellaneous	36,482,532	2,184,921	(151,915)	38,515,538
Residential mortgage-backed	62,238,632	2,001,534	(680,034)	63,560,132
Commercial mortgage-backed	17,830,253	859,758	(12,721)	18,677,290
Common stock	11,973	227,766	–	239,739
Preferred stock	811,306	462,589	(40,486)	1,233,409
	$163,831,600	$ 7,521,065	$ (1,101,380)	$170,251,285

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.

2. Investments (continued)

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, 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)**

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
December 31, 2010						
Government	$ 937,205	$ (13,333)	$ –	$ –	$ 937,205	$ (13,333)
Government agency	973,156	(23,598)	–	–	973,156	(23,598)
State and municipality	8,392,807	(179,293)	–	–	8,392,807	(179,293)
Industrial and miscellaneous	5,376,026	(125,678)	335,175	(26,237)	5,711,201	(151,915)
Residential mortgage-backed	15,544,671	(307,080)	4,200,780	(372,954)	19,745,451	(680,034)
Commercial mortgage-backed	530,848	(2,561)	593,750	(10,160)	1,124,598	(12,721)
Preferred stock	–	–	360,020	(40,486)	360,020	(40,486)
	$ 31,754,713	$ (651,543)	$ 5,489,725	$ (449,837)	$37,244,438	$ (1,101,380)

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 56 securities in an unrealized loss position at December 31, 2011. Over 83% of these investments are investment-grade at December 31, 2011. 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, 2011.

Proceeds from sales of investments in fixed-maturity and equity securities during 2011 and 2010 were $16,947,024 and $14,839,784, respectively.

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

	2011	2010
Realized gains:		
Fixed-maturity securities	**$ 1,048,869**	$ 931,982
Equity securities	**78,489**	132,009
Gross realized gains	**1,127,358**	1,063,991
Realized losses:		
Fixed-maturity securities	**(177,939)**	(252,479)
Equity securities	–	(174)
Other-than-temporary impairment losses on fixed-maturity securities	**(510,401)**	(310,324)
Gross realized losses	**(688,340)**	(562,977)
Net realized investment gains	**$ 439,018**	$ 501,014

2. Investments (continued)

The following schedule details the maturities of the Company's fixed-maturity securities, available-for-sale, as of December 31, 2011:

	Amortized Cost	Fair Value
Due in one year or less	$ 8,765,341	$ 8,902,387
Due after one year through five years	47,523,135	49,934,839
Due after five years through ten years	30,545,439	32,721,032
Due after ten years	3,323,980	3,569,358
Residential mortgage-backed securities	71,343,762	74,035,996
Commercial mortgage-backed securities	16,702,809	17,388,545
	$ 178,204,466	$ 186,552,157

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 $1,833,284 of mortgage-backed securities collateralized by subprime residential loans, which represent approximately 1% of the Company's total investments as of December 31, 2011. The Company does not hold any collateralized debt obligations or mortgage derivatives.

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

	2011	**2010**
Interest on investments	**$ 6,398,614**	$ 6,812,287
Dividends	**87,096**	76,074
Gross investment income	**6,485,710**	6,888,361
Investment expenses	**(268,821)**	(320,942)
Net investment income	**$ 6,216,889**	$ 6,567,419

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 $17,649,223 and $16,992,062 at December 31, 2011 and 2010, respectively.

3. Deferred Acquisition Costs

Changes in deferred acquisition costs are as follows for the years ended December 31:

	2011	2010
Balance, beginning of year	**$ 5,015,245**	$ 5,381,659
Capitalized costs	**21,783,942**	26,507,853
Amortization	**(22,688,540)**	(26,874,267)
Balance, end of year	**$ 4,110,647**	$ 5,015,245

4. Property, Equipment, and Depreciation

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

	2011	2010
Land held for use	**$ 2,405,763**	$ 2,405,763
Land held for sale	**1,034,000**	1,034,000
Building and improvements	**15,370,537**	15,367,924
Transportation equipment	**2,658,334**	2,718,479
Furniture and fixtures	**3,238,494**	3,229,302
Computer equipment and software	**4,952,064**	4,731,393
	29,659,192	29,486,861
Accumulated depreciation and amortization	**(8,744,344)**	(7,095,159)
Property and equipment, net	**$ 20,914,848**	$ 22,391,702
Depreciation and amortization expense	**$ 2,073,787**	$ 2,128,781

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 $91,935 and $38,969 were recognized at December 31, 2011 and 2010, 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, 2011			
Goodwill	**$ 2,565,390**	**$ –**	**$ 2,565,390**
Customer relationships/lists	**20,449,606**	**(13,810,507)**	**6,639,099**
Non-compete agreements	**3,338,790**	**(1,894,955)**	**1,443,835**
	$ 26,353,786	**$ (15,705,462)**	**$ 10,648,324**
December 31, 2010			
Goodwill	$ 2,565,390	$ –	$ 2,565,390
Customer relationships/lists	20,449,606	(12,747,678)	7,701,928
Non-compete agreement	3,790,591	(984,508)	2,806,083
	$ 26,805,587	$ (13,732,186)	$ 13,073,401

On January 5, 2010, the Company acquired the exclusive rights from Finegold Insurance Associates, Inc. to sell CPI products to certain credit unions (the Transaction). The Transaction was accounted for using the purchase method of accounting under ASC 805, *Business Combinations*. The purchase price of $8 million was paid in cash by the Company at closing of the Transaction and has been allocated to the assets acquired and liabilities assumed, based on their fair values as of January 5, 2010. The fair value of the intangible assets acquired and respective amortization periods are as follows:

Customer relationships/lists	$ 4,240,000	15 years
Non-compete agreement	$ 3,310,000	5 years

The excess of the purchase price over the fair value of the net assets acquired of $450,000 has been allocated to goodwill. Goodwill is not amortized. Customer relationships/lists are amortized based on discounted cash flow estimates over their expected useful lives of 15 years.

5. Goodwill and Intangible Assets (continued)

Amortization expense related to the customer relationships/lists was $1,062,828 and $923,308 for the years ended December 31, 2011 and 2010, 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 $910,447 and $563,452 for the years ended December 31, 2011 and 2010, respectively. During 2011, the Company recorded an impairment of $451,801 on the Finegold non-competition agreement, 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.

Expected amortization expense over the next five years for the Company's customer relationships/lists and non-compete agreements is as follows: 2012 – $1,407,560; 2013 – $1,332,006; 2014 – $1,243,038; 2015 – $744,684; and 2016 – $707,183.

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.

6. Subordinated Debentures (continued)

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

	2011	2010
Floating Rate Capital Securities at LIBOR plus 4%, 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, 2011 was .53%. 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.

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 $421,893 at December 31, 2011 and $371,418 at December 31, 2010) and are being amortized over 30 years using the straight-line method, which approximates the effective interest method.

6. Subordinated Debentures (continued)

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, 2011 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, 2011 and 2010, are as follows:

December 31, 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**

December 31, 2010	**Federal**	**State**	**Total**
Federal and state income tax expense			
Current	$ 3,396,699	$ 732,403	$ 4,129,102
Deferred	1,261,656	–	1,261,656
Total income tax expense	$ 4,658,355	$ 732,403	$ 5,390,758

7. Income Tax Provision (continued)

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:

	2011	2010
Deferred income tax assets:		
Allowance for policy cancellations	**$ 5,251,587**	$ 5,366,263
Unpaid losses and loss adjustment expenses	**201,158**	281,055
Deferred ceding commissions	**4,756,997**	4,102,887
Management fee	**1,555,602**	1,666,009
Write-down of other-than-temporary impaired investment securities	**529,858**	382,533
Charitable contribution carryforward	**–**	110,832
Other	**55,694**	–
Total deferred income tax assets	**12,350,896**	11,909,579
Deferred income tax liabilities:		
Unearned premiums	**3,070,034**	2,991,684
Unrealized gains on investment securities	**3,034,154**	2,217,117
Deferred acquisition costs	**2,751,666**	2,989,364
Contingent commissions	**2,671,293**	2,642,580
Other	**348,460**	606,514
Total deferred income tax liabilities	**11,875,607**	11,447,259
Net deferred income tax asset	**$ 475,289**	$ 462,320

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:

	2011		**2010**	
	Amount	**Effective Tax Rate**	**Amount**	**Effective Tax Rate**
Expected tax expense	**$ 11,276,668**	**34.3%**	$ 10,780,736	34.3%
Exclusion of Subchapter S status	**(6,505,681)**	**(19.8)**	(5,809,154)	(18.5)
Tax-exempt income	**(311,124)**	**(0.9)**	(276,901)	(0.9)
State income taxes	**731,000**	**2.2**	687,631	2.2
Other	**(220,692)**	**(0.7)**	8,446	0.1
Total income tax expense	**$ 4,970,171**	**15.1%**	$ 5,390,758	17.2%

At December 31, 2010, the Company had a charitable contribution carryforward of $111,124 that would have expired in 2013. The Company fully utilized this carryforward in 2011.

The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expenses. There were no penalties or interest recognized during 2011 and 2010. Tax years that ended December 31, 2008 through December 31, 2011, are open for 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.

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:

	2011	**2010**
Ceded unearned premiums	**$ 276,443,005**	$ 238,393,877
Ceded loss and loss adjustment expense reserves	**797,961,132**	696,169,853
Total reinsurance receivables	**1,074,404,137**	934,563,730
Secured balances	**(590,609,503)**	(451,151,114)
Unsecured reinsurance receivables	**$ 483,794,634**	$ 483,412,616

SNIC, NSIC, and USIC hold collateral securing $590,609,503 of ceded balances at December 31, 2011. The fair value of the collateral is approximately 134% of the related receivables as of December 31, 2011.

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 (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: Substantially all fixed-maturity investments are 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.

9. Fair Value Measurements (continued)

The remaining fixed-maturity securities are reported at fair value utilizing Level 3 inputs. These securities are priced by the investment managers utilizing cash flow analyses with unobservable inputs.

- 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, 2011 and 2010, have been categorized as follows:

	Level 1	Level 2	Level 3	December 31 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)

	Level 1	Level 2	Level 3	December 31 2010
Investments				
Fixed-maturity securities (available-for-sale):				
Government	$ –	$ 7,330,416	$ –	$ 7,330,416
Government agency	–	3,786,335	–	3,786,335
State and municipality	–	36,908,426	–	36,908,426
Industrial and miscellaneous	–	38,515,538	–	38,515,538
Residential mortgage-backed	–	62,492,742	1,067,390	63,560,132
Commercial mortgage-backed	–	18,677,290	–	18,677,290
Equity securities (available-for-sale)	–	1,473,148	–	1,473,148
	$ –	$ 169,183,895	$ 1,067,390	$ 170,251,285

A reconciliation of the beginning and ending balances for the fixed maturity securities categorized as Level 3 during the year ended December 31, 2011 and 2010, is as follows:

	2011	2010
Beginning balance, January 1	**$ 1,067,390**	$ 1,817,940
Total gains or losses:		
Included in realized net investment gains	**(244,503)**	(323,930)
Included in other comprehensive income	**22,661**	195,823
Purchases and issuances	**–**	–
Sales and settlements	**–**	–
Transfers out of Level 3	**(34,216)**	(622,443)
Ending balance, December 31	**$ 811,332**	$ 1,067,390

Transfers between levels are recognized at the end of the reporting period. The security transferred out of Level 3 was transferred into Level 2. In the prior year, this security was 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 2011, third-party pricing of the transferred security was more reflective of the value of the security in a liquid rather than a distressed market.

9. Fair Value Measurements (continued)

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:

	2011	2010
Premiums written	**$711,188,332**	$668,750,094
Premiums assumed	**1,646,181**	(396,998)
Premiums ceded	**(632,531,332)**	(579,754,822)
Net premiums retained	**80,303,181**	88,598,274
Change in net unearned premiums	**1,671,204**	1,646,004
Total premiums earned	**$ 81,974,385**	$ 90,244,278

Premiums written 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:

	2011	2010
Direct losses and loss adjustment expenses	**$588,644,386**	$529,815,306
Assumed losses and loss adjustment expenses	**600,310**	148,468
Ceded losses and loss adjustment expenses	**(559,612,549)**	(496,633,198)
Total net losses and loss adjustment expenses	**$ 29,632,147**	$ 33,330,576

11. Losses and Loss Adjustment Expenses (continued)

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

	2011	2010
Balance at January 1	**$ 706,290,795**	$ 588,489,823
Reinsurance receivables	**(696,169,853)**	(574,974,076)
Net balance at January 1	**10,120,942**	13,515,747
Incurred related to:		
Current year	**32,284,841**	36,894,777
Prior year	**(2,652,694)**	(3,564,201)
Total incurred	**29,632,147**	33,330,576
Paid related to:		
Current year	**26,834,489**	29,710,474
Prior year	**4,754,331**	7,014,907
Total paid	**31,588,820**	36,725,381
Net balance at December 31	**8,164,269**	10,120,942
Reinsurance receivables	**797,961,132**	696,169,853
Balance at December 31	**$ 806,125,401**	$ 706,290,795

The estimate for ultimate losses incurred related to prior years decreased by $2,652,694 and $3,564,201 in 2011 and 2010, respectively, primarily as a result of re-estimation of unpaid losses and loss adjustment expenses, principally on commercial auto, commercial multi peril and credit lines of insurance in 2011 and on commercial auto and credit lines of insurance in 2010. The net changes in 2011 and 2010 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:

	2011	2010
Shareholders' equity (insurance subsidiaries only):		
Per statutory basis	**$ 140,708,366**	$ 131,357,791
Adjustments for:		
Allowance for return commissions	**13,414,175**	13,618,156
Allowance for policy cancellations	**(13,166,445)**	(13,550,532)
Commissions payable	**7,788,027**	7,704,316
Deferred acquisition costs	**8,022,349**	8,715,347
Deferred income taxes	**(6,972,187)**	(6,344,267)
Unrealized gain on investments available-for-sale	**8,561,484**	6,125,801
Management fees	**(4,535,284)**	(4,857,169)
Intangible assets	**1,947,092**	1,947,092
Nonadmitted assets	**30,453**	46,824
Other	**212,317**	143,432
Shareholders' equity in accordance with GAAP	**$ 156,010,347**	$ 144,906,791

	2011	2010
Net income (insurance subsidiaries only):		
Per statutory basis	**$ 8,745,667**	$ 10,470,769
Adjustments for:		
Allowance for return commissions	**(203,981)**	645,837
Allowance for policy cancellations	**384,087**	(1,475,611)
Commission expense	**83,711**	3,346,680
Deferred acquisition costs	**(692,998)**	(483,026)
Deferred income taxes	**830,451**	(1,261,656)
Management fees	**321,885**	(1,554,246)
Other	**68,885**	16,720
Net income in accordance with GAAP	**$ 9,537,707**	$ 9,705,467

12. Statutory Accounting (continued)

At December 31, 2011 and 2010, the amount of statutory capital and surplus for the consolidated insurance subsidiaries was $140,708,366 and $131,357,791, respectively. At December 31, 2011 and 2010, 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, 2011, unrestricted net assets available for dividends were $14,070,837.

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 2011 or 2010. However, if the Company had not used this practice in the NSIC RBC calculation, a regulatory event would have resulted in 2011 and 2010.

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 December 31, 2006 through December 31, 2010 statutory-basis financial statements of NSIC and SNIC are currently under the examination of the Department, with examination completion estimated to be in 2012. The December 31, 2006 through December 31, 2010 statutory-basis financial statements of USIC are currently under examination by the Delaware Insurance Department, with examination completion expected to be in 2012.

13. Related-Party Transactions

The accompanying consolidated financial statements include other payables to an affiliate, Trace Air, Inc., in the amounts of $235,624 and $109,000 as of December 31, 2011 and 2010, 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 recorded a pretax gain of $2,300,000 in 2009 and recognized $663,234 and $586,766 of contingent consideration in 2011 and 2010, respectively.

14. Comprehensive Income

Total comprehensive income for the year ended 2011 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 $5,971,124 and $4,349,705 as of December 31, 2011 and 2010, respectively, and is comprised solely of unrealized gains and losses on available-for-sale securities, net of federal income taxes.

The components of other comprehensive income are as follows:

	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**

14. Comprehensive Income (continued)

	Gross Amount	Tax Effect	Net Amount
December 31, 2010			
Unrealized gains arising during the period	$ 3,005,943	$ 996,430	$ 2,009,513
Reclassification for securities sold or impaired during the period	(579,675)	(198,778)	(380,897)
Net unrealized gains arising during the period	2,426,268	797,652	1,628,616
Other comprehensive income	$ 2,426,268	$ 797,652	$ 1,628,616

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

The Company has a 401(k) profit-sharing plan for employees that cover 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 $1,005,627 and $1,164,542 for the years ended December 31, 2011 and 2010, 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.

A significant portion of the Company's writings occurs in California, Texas, New York, Florida, and New Jersey. Seven customers comprised approximately 11% of the Company's CPI writings. Three reinsurers represent 67% 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, 2011 and 2010 is $1,346,254 and $1,346,254, respectively. Future minimum lease payments associated with the lease are as follows: 2012 – $1,310,603; 2013 – $1,289,242; 2014 – $1,295,382; 2015 – $1,362,914; 2016 – $1,362,914.

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 30, 2012, which is the date the consolidated financial statements were available to be issued.

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