

# Accident Fund Insurance Company of America and Subsidiaries

Consolidated Financial Statements as of and  
for the Years Ended December 31, 2008 and  
2007, and Independent Auditors' Report

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

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## INDEPENDENT AUDITORS' REPORT

To the Shareholder and Board of Directors of  
Accident Fund Insurance Company of America and Subsidiaries  
Lansing, Michigan

We have audited the accompanying consolidated balance sheets of Accident Fund Insurance Company of America and subsidiaries (the "Group") as of December 31, 2008 and 2007, and the related consolidated statements of operations, shareholder's equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the consolidated financial statements of CWI Holdings, Inc. and subsidiaries (a consolidated subsidiary) as of December 31, 2007 and for the period November 20, 2007 (date of acquisition) to December 31, 2007, which statements reflect total assets and total revenue constituting 8% and 2%, respectively, of consolidated total assets as of December 31, 2007, and total revenues for the year then ended. Those consolidated financial statements were audited by other auditors whose report (which contains a qualification for the omission of consolidated statements of cash flows and stockholder's equity, the effect of which, in our opinion, is not material in relation to the consolidated financial statements) has been furnished to us, and our opinion, insofar as it relates to the amounts included for CWI Holdings, Inc. and subsidiaries is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of Accident Fund Insurance Company of America and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, effective December 31, 2007, the Group began to recognize the funded status of its benefit plans in its consolidated balance sheet to conform to Financial Accounting Standards Board Statement No. 158.

*Deloitte & Touche LLP*

February 27, 2009

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2008 AND 2007 (In thousands)

	2008	2007
<b>ASSETS</b>		
Investments:		
Available-for-sale securities	\$ 1,048,402	\$ 1,043,113
Trading securities	<u>511,040</u>	<u>645,452</u>
Total investments	1,559,442	1,688,565
Cash and cash equivalents	181,457	195,715
Securities lending collateral	109,856	337,165
Receivable from sale of securities	134	72,462
Premiums receivable — net	328,006	324,154
Reinsurance recoverables	233,372	283,454
Property and equipment — net	69,048	45,378
Deferred income taxes	136,408	77,259
Goodwill and intangible assets	141,227	138,876
Other assets	<u>105,801</u>	<u>102,441</u>
<b>TOTAL</b>	<u><b>\$ 2,864,751</b></u>	<u><b>\$ 3,265,469</b></u>
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>		
<b>LIABILITIES:</b>		
Losses and loss adjustment expenses	\$ 1,306,166	\$ 1,337,459
Unearned premiums and other	363,002	349,054
Assessments, taxes, and fees payable	30,047	35,879
Securities lending collateral payable	109,856	337,165
Payable for purchases of securities	32,141	173,876
Note payable	49,758	
Junior subordinated debt	20,619	20,619
Other liabilities	<u>169,957</u>	<u>170,092</u>
Total liabilities	<u>2,081,546</u>	<u>2,424,144</u>
<b>SHAREHOLDER'S EQUITY:</b>		
Common stock, \$10 par value — authorized, 1,000,000 shares; issued and outstanding, 300,000 shares	3,000	3,000
Additional paid-in capital	396,088	396,088
Accumulated other comprehensive (loss) income	(12,480)	14,071
Retained earnings	<u>396,597</u>	<u>428,166</u>
Total shareholder's equity	<u>783,205</u>	<u>841,325</u>
<b>TOTAL</b>	<u><b>\$ 2,864,751</b></u>	<u><b>\$ 3,265,469</b></u>

See notes to consolidated financial statements.

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (In thousands)

	2008	2007
REVENUES:		
Net premiums earned	\$ 859,692	\$ 698,926
Net investment and other income	82,068	71,752
Net (losses) gains on investments	<u>(149,070)</u>	<u>40,974</u>
Total revenues	<u>792,690</u>	<u>811,652</u>
LOSSES AND EXPENSES:		
Losses	505,782	410,616
Loss adjustment expenses	94,501	50,292
Operating and other expenses	205,115	168,544
Policyholder dividends	34,262	33,164
Interest expense	<u>1,826</u>	<u>542</u>
Total losses and expenses	<u>841,486</u>	<u>663,158</u>
(LOSS) INCOME BEFORE FEDERAL INCOME TAX (BENEFIT) EXPENSE	(48,796)	148,494
FEDERAL INCOME TAX (BENEFIT) EXPENSE	<u>(18,047)</u>	<u>51,184</u>
(LOSS) INCOME BEFORE EXTRAORDINARY GAIN	(30,749)	97,310
EXTRAORDINARY GAIN	<u>          </u>	<u>856</u>
NET (LOSS) INCOME	(30,749)	98,166
OTHER COMPREHENSIVE LOSS — Net of tax	<u>(26,551)</u>	<u>(1,288)</u>
COMPREHENSIVE (LOSS) INCOME	<u>\$ (57,300)</u>	<u>\$ 96,878</u>

See notes to consolidated financial statements.

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

(In thousands)

	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholder's Equity
BALANCE — January 1, 2007	\$ 3,000	\$271,088	\$ 15,478	\$330,000	\$619,566
Net income				98,166	98,166
Capital contribution		125,000			125,000
Cumulative change on reclassification from available-for-sale category to trading category — net of tax			(11,901)		(11,901)
Change in unrealized gains on investments — net of tax			10,194		10,194
Other changes in other comprehensive income — net of tax			419		419
Cumulative effect from adoption of FASB Statement No. 158 — net of tax			(119)		(119)
BALANCE — December 31, 2007	3,000	396,088	14,071	428,166	841,325
Net loss				(30,749)	(30,749)
Change in unrealized losses on investments — net of tax			(21,505)		(21,505)
Other changes in other comprehensive income — net of tax			(5,046)		(5,046)
Cumulative effect from adoption of FASB Statement No. 158 measurement date provision— net of tax				(820)	(820)
BALANCE — December 31, 2008	<u>\$ 3,000</u>	<u>\$396,088</u>	<u>\$ (12,480)</u>	<u>\$396,597</u>	<u>\$783,205</u>

See notes to consolidated financial statements.

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (In thousands)

	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Cash received from premiums collected — net of reinsurance	\$ 873,903	\$ 708,041
Cash paid for:		
Losses and loss adjustment expenses	(588,816)	(440,735)
Underwriting expenses	(185,015)	(146,736)
Total	(773,831)	(587,471)
Other expenses	(58,529)	(36,089)
Net purchases, sales, and maturities of trading securities	(6,323)	
Interest, dividends, and rental income received	82,839	72,813
Federal income taxes paid	(44,432)	(51,791)
Net cash provided by operating activities	<u>73,627</u>	<u>105,503</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of investments	(1,112,539)	(3,349,664)
Proceeds from sale and maturity of investments	1,008,234	3,326,995
Payment for purchase of subsidiaries — net of cash acquired	(395)	(114,606)
Purchase of property, equipment, and other assets	(34,682)	(13,807)
Proceeds from sale of property and equipment	1,739	
Net cash used in investing activities	<u>(137,643)</u>	<u>(151,082)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Capital contribution from parent		125,000
Borrowings on note payable	50,000	
Repayment of notes payable	(242)	
Dividend to shareholder		(12,000)
Net cash provided by financing activities	<u>49,758</u>	<u>113,000</u>
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(14,258)</b>	<b>67,421</b>
<b>CASH AND CASH EQUIVALENTS — Beginning of year</b>	<b>195,715</b>	<b>128,294</b>
<b>CASH AND CASH EQUIVALENTS — End of year</b>	<b>\$ 181,457</b>	<b>\$ 195,715</b>
<b>RECONCILIATION OF NET (LOSS) INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:</b>		
Net (loss) income	\$ (30,749)	\$ 98,166
Adjustment to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation	9,186	7,145
Loss (gain) on investments and equipment	149,131	(40,525)
Amortization of bond premium and discounts	2	(1,367)
Amortization of intangible assets	5,453	
Net purchases, sales, and maturities of trading securities	(6,323)	
Deferred income tax benefit	(53,808)	6,931
Other non-cash adjustments		(858)
Changes in assets and liabilities:		
Receivables and other assets	38,298	27,656
Liability for losses and loss adjustment expenses	(28,664)	7,774
Unearned premiums	13,948	16,375
Assessments, taxes, and other liabilities	(22,847)	(15,794)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>\$ 73,627</b>	<b>\$ 105,503</b>

See notes to consolidated financial statements.

# ACCIDENT FUND INSURANCE COMPANY OF AMERICA AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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### 1. ORGANIZATION

Our consolidated financial statements include the accounts of Accident Fund Insurance Company of America (the “Company”) and its wholly-owned direct and indirect subsidiaries. The Company is a wholly-owned subsidiary of Blue Cross Blue Shield of Michigan (BCBSM).

Subsidiaries of the Company include the following: Accident Fund National Insurance Company (“National”), Accident Fund General Insurance Company (“General”), United Wisconsin Insurance Company (UWIC), Third Coast Insurance Company (TCIC), and CWI Holdings, Inc. (CWIH), including its wholly-owned subsidiaries, CompWest Insurance Company (“CompWest”) and Howard Street Insurance Services. In addition, CWIH owns 100% of the common securities of a Delaware statutory trust formed in June 2006, CWI Holdings 2006 Statutory Trust I (“Trust I”). In accordance with Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)* — an interpretation of ARB No. 51, we have not consolidated Trust I into these financial statements.

Through the Company and its subsidiaries, we sell workers’ compensation insurance and services to companies located primarily in several Midwestern and Southeastern states and in California. Our companies are licensed to write primary insurance in 49 states and the District of Columbia as of December 31, 2008.

### 2. SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** — We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). These principles differ in some respects from statutory accounting principles, which we use in preparing reports to state insurance regulatory authorities. (See Note 21).

**Principles of Consolidation** — We have eliminated all significant intercompany balances and transactions in consolidation.

**Cash and Cash Equivalents** — Cash and cash equivalents include readily marketable securities having initial maturities of 90 days or less. We carry cash and cash equivalents at cost, which approximates fair value.

**Short-Term Investments** — Short-term investments include commercial paper, certificates of deposit, and other readily marketable investments with initial maturities over 90 days but less than one year.

**Disclosures About Fair Value of Financial Instruments** — We classify our investments in all debt securities and equity securities with readily determinable fair values as either available-for-sale securities or trading securities.

*Trading Securities* — Effective December 31, 2007, we classify debt and equity securities as trading securities if (1) we have bought them for short-term resale or (2) they are part of a portfolio managed by external investment managers who have broad authority to buy and sell securities without our prior approval. These securities are reported at fair value with unrealized gains and losses included in earnings. Previously, we had reported no securities as trading securities. As of December 31, 2007, we reclassified \$656,923,245 of securities from the available-for-sale category to the trading category and as a result, recognized \$18,309,538 of pre-tax gains in earnings.

*Available-for-Sale Securities* — Short-term investments and debt and equity securities not considered trading securities are classified as available-for-sale and are reported at fair value. Unrealized gains and losses on these securities are excluded from net income but are recorded as a separate component of comprehensive earnings and shareholder's equity, net of deferred income taxes.

Fair values of debt and equity securities are based on quoted market prices, where available. We obtained one price for each security, primarily from a third party pricing service (pricing service), which generally uses Level 1 or Level 2 inputs for the determination of fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*. The pricing service normally derives the security prices through recently reported trades for identical (Level 1) or similar securities (Level 2), making adjustments through the reporting date based upon available observable market information. For securities not actively traded, the pricing service may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, non-binding broker quotes, benchmark yields, credit spreads, default rates, and prepayment speeds. We perform monthly analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. Some of these estimates are subjective in nature and involve uncertainties and matters of considerable judgment. The use of different assumptions, judgments, and estimation methodologies may have a material effect on the estimated fair values. Accordingly, the fair values presented in these statements do not necessarily represent the amounts we could realize in a current market exchange.

Realized gains and losses on disposition of investments are based on specific identification of the investments sold.

Financial futures and forward contracts are commitments to purchase or sell designated financial instruments at a future date for a specified price or yield. They may be settled in cash or through delivery. Most of the securities we purchase settle within normal time requirements and therefore are not considered futures or forward contracts. We do periodically purchase "to-be-announced" securities that settle more than 30 days from the trade date. We consider such securities to be forwards and account for increases or decreases in the fair value as basis adjustments, with the change flowing through the consolidated statements of operations. As of December 31, 2008 and 2007, we had no commitments to purchase any security expected to settle outside normal time requirements.

**Financial Instrument Impairment** — We regularly review the values of our available-for-sale investments. If this review suggests that a decline in fair value is other than temporary, we reduce the carrying value in the investment to its fair market value and record the reduction through the consolidated statements of operations as a realized loss on investments. The principal factors we consider in determining whether a decline in fair value is other than temporary are the length of time the fair value of the investment has been below the carrying value and the financial condition, operating performance, and near-term prospects of the investee. In addition, we consider whether the decline in fair value is due to general market conditions, industry-specific conditions, or investee-specific conditions; changes in valuation after the balance sheet date; and our intent and ability to hold the

investment long enough for its fair value to recover. Our assessment of these factors involves a high degree of judgment and, accordingly, actual results may differ materially from our estimates and judgments.

**Premiums, Unearned Premiums, and Premiums Receivable** — We recognize premiums as earned over the policy terms using the daily pro rata method. Unearned premiums represent the portion of written premium that relates to the unexpired term of the policies in force. Premiums receivable represent (a) premiums we have billed but which our policyholders have not yet paid, (b) future premium installments we have not yet billed, and (c) estimates of additional earned but unbilled premiums which we project will result from policy audits. Premiums receivable are reported net of an allowance for doubtful accounts.

**Deferred Policy Acquisition Costs** — The costs directly related to writing or renewing insurance policies are referred to as policy acquisition costs and consist of commissions, premium-based taxes and assessments, and certain other direct underwriting expenses. Although these costs are typically paid when we issue a policy, we defer and amortize them over the same period as the corresponding premiums are earned. We continually review deferred policy acquisition costs for recoverability and consider anticipated investment income in this analysis as well as in determining whether deficiency reserves are necessary.

**Liability for Losses and Loss Adjustment Expenses** — Losses represent the amounts we expect to pay for reported and unreported claims, reduced for estimated recoveries from third parties. The costs of investigating, resolving, and processing these claims are known as loss adjustment expenses.

The liability for losses and loss adjustment expenses is an estimate based on actuarial and other assumptions related to the ultimate cost to settle such claims. Because losses depend upon factors such as duration of worker disability, medical cost trends, occupational disease, inflation, and life expectancy, the process we use to establish the liability for losses and loss adjustment expenses is necessarily based on judgments. We continually review our reserves using a variety of statistical and actuarial techniques to analyze current claims costs, frequency and severity data, and economic and legal factors. As loss experience develops and new information becomes available, we adjust the liability established in prior years. Adjustments resulting from revisions of the estimates of the liability for losses and loss adjustment expenses are reflected in our results of operations in the period in which they are determined.

We believe the liability for losses and loss adjustment expenses at December 31, 2008, is adequate to meet our future obligations.

**Reinsurance** — We record reinsurance recoverables and ceded unearned premiums as assets. The balances of these items are calculated in a manner consistent with the underlying reinsured losses and insurance contracts.

**Goodwill of Acquired Business** — Goodwill on acquisitions accounted for under the purchase method represents the difference between purchase price and the fair value of net assets acquired. We review goodwill annually for impairment using a variety of methods. Impairments, if any, are charged to earnings.

**Intangible Assets** — We hold various intangible assets with useful lives ranging from one year to indefinite periods. Where the useful life can be estimated, we amortize the cost of the asset over its useful life and charge that amortization expense to operations in the period in which it occurs. We review intangible assets annually for impairment using a variety of methods. Impairments, if any, are charged to earnings.

**Impairment of Long-Lived Assets** — We routinely review long-lived assets, such as certain real estate holdings, to test for impairment of carrying values. We record a loss if the carrying amount of a long-lived asset is not recoverable from projected undiscounted cash flows. In such a situation, the amount of the loss is the difference between the carrying amount and fair value of the asset.

**Policyholder Dividends** — We record policyholder dividends as an expense over the effective period of the related policies.

**Insurance-Related Assessments** — We recognize liabilities for insurance-related assessments when an assessment has been imposed. We also recognize such liabilities when available information indicates an assessment is likely to be imposed, the event giving rise to the assessment has occurred, and we can reasonably estimate the assessment.

**Health Care Benefits** — We self-insure certain medical, dental, vision, and short-term disability benefits provided to some of our employees. Liabilities for such benefits are based on actual claim data and estimates of incurred-but-not-reported claims developed by use of historical claim trends. Actual settlements and claims could differ materially from these estimates.

**Income Taxes** — We account for income taxes using the asset and liability method. Under this method, we calculate the tax effect, using current tax rates, of temporary differences between carrying values of assets and liabilities for financial reporting purposes and the bases of such assets and liabilities as measured by tax laws and regulations. The effect on deferred taxes for a change in tax rates is recognized in income in the period that includes the enactment date.

**Property and Equipment** — We report property and equipment at cost, less accumulated depreciation. We depreciate these assets in equal annual amounts over their estimated useful lives, which range from two-and-half years to 40 years.

**Consolidation of Variable Interest Entities** — As discussed in Note 11 and 19, the Company has entered an agreement with a developer to construct a new corporate headquarters building for the Company in Lansing, Michigan. The Company has loaned approximately \$25 million to a development company created by the developer solely to provide for the construction of the new corporate headquarters. As defined in FIN No. 46(R), an enterprise shall consolidate a variable interest entity if that enterprise has a variable interest that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. We have evaluated the Company's investment in the development company and have determined that it is a variable interest entity. As such, we have recognized approximately \$25 million of construction in progress in the consolidated financial statements under property and equipment.

**New Accounting Standards** — In September 2006, the FASB issued FASB Statement No. 157 which defines fair value, establishes a framework for measuring fair value, expands disclosures about fair value measurements, and specifies a hierarchy of valuation techniques. Following are the levels of the hierarchy and a brief description of the type of valuation information ("inputs") that qualify a financial asset for each level:

*Level 1* — Unadjusted quoted prices for identical assets or liabilities in active markets

*Level 2* — Inputs other than Level 1 that are based on observable market data, including quoted prices for similar assets in active markets, quoted prices for identical assets in inactive markets, and inputs derived principally from or corroborated by observable market data by correlation or other means.

*Level 3* — Unobservable inputs reflecting the Group's own assumptions based on the best information available in the circumstances.

We adopted FASB Statement No. 157 in 2008. The only financial instruments measured at fair value are the Company's investments in debt and equity securities. Therefore, the adoption of FASB Statement No. 157 did not have a material impact on our consolidated financial position or results of operations.

In September 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. FASB Statement No. 158 requires employers to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year end statement of financial position (with limited exceptions), recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position, and recognize changes in that funded status in the year in which the changes occur through changes in comprehensive income. Prior standards relegated this information to the notes to financial statements. This statement does not change the basic approach to measuring plan assets, benefit obligations, or annual net periodic benefit costs. Therefore, no new information or new computations other than those related to income tax effects are required. Retrospective revision of financial statements from prior periods is not required. The provision to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures must be applied by the fiscal year ending after June 15, 2007. The provision to measure plan assets and benefit obligations as of the date of the employer's fiscal year end statement of financial position is effective for fiscal years ending after December 15, 2008. We adopted the reporting provisions of this statement as of calendar year-end 2007 and adopted the measurement provisions as of calendar year-end 2008.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115*. The objective of FASB Statement No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported net income caused by measuring related assets and liabilities differently. This statement permits entities to choose, at specified election dates, to measure eligible items at fair value (i.e., the fair value option). Items eligible for the fair value option include certain recognized financial assets and liabilities, rights and obligations under certain insurance contracts that are not financial instruments, most financial instruments resulting from the separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument, and certain commitments. Business entities shall report unrealized gains and losses on items for which the fair value option has been elected in net income. The fair value option (a) may be applied instrument by instrument, with certain exceptions, (b) is irrevocable (unless a new election date occurs), and (c) is applied only to entire instruments and not to portions of instruments. FASB Statement No. 159 was effective in 2008; however, the Company chose not to apply and therefore has no impact on the Company's financial statements.

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*. Among other things, FIN No. 48 creates a model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing a minimum recognition threshold which all income tax positions must achieve before being recognized in the financial statements. In addition, FIN No. 48 requires expanded annual disclosures, including a rollforward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within 12 months. FIN No. 48 is effective for the Company for financial periods beginning after January 1, 2009. Any differences between the amounts recognized in the statements of financial position prior to the adoption of FIN No. 48 and the amounts reported after

adoption are generally accounted for as a cumulative-effect adjustment recorded to the beginning balance of shareholder's equity. We have completed a preliminary evaluation of the impact of the adoption of FIN No. 48 and have determined that such adoption is not expected to have a material impact on the Company's financial statements.

In December 2007, the FASB issued FASB Statement No. 141(R), *Business Combinations*. The objective of FASB Statement No. 141(R) is to improve the financial reporting of business combinations. This statement retains a substantial portion of the requirements contained in the original FASB Statement No. 141, but requires acquired assets and liabilities to be valued at fair market value instead of using a purchase price allocation process. FASB Statement No. 141(R) also requires that acquisition related costs be expensed as incurred and restructuring costs contemplated at the time of acquisition be accounted for separately from the business combination. FASB Statement No. 141(R) is effective for acquisitions occurring after January 1, 2009.

In December 2007, the FASB issued FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, which establishes accounting and reporting standards that require (i) the ownership interest in subsidiaries held by parties other than the parent to be clearly identified and presented in the consolidated balance sheet within shareholder's equity, but separate from the parent's equity, (ii) the amount of consolidated net income attributable to the parent and the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of operations, and (iii) changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary to be accounted for consistently. FASB Statement No. 160 applies to fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. We do not expect the adoption of FASB Statement No. 160 to have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows. FASB Statement No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. We are currently evaluating the provisions of FASB Statement No. 161; however, it is not expected to have a material impact on the Company's consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (FSP) FAS 142-3, *Determination of Useful Life of Intangible Assets*. FSP FAS 142-3 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142. FSP FAS No. 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives and is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. We have not yet commenced evaluating the potential impact, if any, of the adoption of FSP FAS No. 142-3 on the Company's consolidated financial statements.

**Estimates** — The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

### 3. ACQUISITIONS

On August 31, 2007, the Company acquired 100% of the outstanding shares of TCIC, an inactive Illinois property/casualty insurance company, for a total purchase price of \$11,934,570. This amount was \$856,376 less than the fair market value of assets acquired. We recognized the difference between purchase price and fair market value of assets acquired as an extraordinary gain in 2007. Results of operations of TCIC for the period after acquisition through year ended December 31, 2007, are included in the consolidated financial statements for the year ended December 31, 2007. The following table summarizes the fair values of the assets acquired and liabilities assumed at August 31, 2007 (date of acquisition) (in thousands):

Cash and invested assets	\$ 12,457
Recoverable from reinsurers	3,850
Other assets	<u>64</u>
Total assets acquired	<u>16,371</u>
Loss and loss expense reserves	3,234
Other liabilities	<u>346</u>
Total liabilities assumed	<u>3,580</u>
Net assets acquired	<u>\$ 12,791</u>

On November 20, 2007, the Company acquired 100% of the outstanding shares of CWIH, a Delaware-domiciled insurance holding company. The principal subsidiary of CWIH is CompWest Insurance Company, a California-domiciled property/casualty insurance company that writes workers' compensation insurance primarily in California. The acquisition of CWIH gives the Company an established presence in California and the ability to expand in other Western states. Results of operations of CWIH for the period after acquisition through year ended December 31, 2007, are included in the consolidated financial statements for the year ended December 31, 2007.

As of December 31, 2007, the aggregate purchase price of CWIH, including transaction costs, was \$127,409,250 in cash, subject to a final purchase price adjustment. In 2008, after purchase accounting adjustments, the final purchase price was \$127,804,664. Amounts held in escrow will be settled by June 2, 2009.

The following table summarizes the fair values of the assets acquired and liabilities assumed at November 20, 2007 (date of acquisition) (in thousands):

	<b>Preliminary</b>	<b>Purchase Adjustments</b>	<b>Final</b>
Cash and invested assets	\$ 172,430	\$ -	\$ 172,430
Premiums receivable	3,813		3,813
Recoverable from reinsurers	10,395		10,395
Goodwill and intangible assets	59,994	7,804	67,798
Other assets	<u>15,809</u>	<u>(2,182)</u>	<u>13,627</u>
Total assets acquired	<u>262,441</u>	<u>5,622</u>	<u>268,063</u>
Loss and loss expense reserves	90,271	(2,629)	87,642
Unearned premiums	9,002		9,002
Junior subordinated debt	20,619		20,619
Other liabilities	<u>15,140</u>	<u>7,856</u>	<u>22,996</u>
Total liabilities assumed	<u>135,032</u>	<u>5,227</u>	<u>140,259</u>
Net assets acquired	<u>\$ 127,409</u>	<u>\$ 395</u>	<u>\$ 127,804</u>

As part of the estimation of fair value of liabilities assumed, we discounted the historical undiscounted loss reserves and related reinsurance recoverables (the net loss reserves) and added a risk margin, consistent with our understanding of the returns anticipated by the reinsurance market. We also added an additional risk margin in consideration of the long-tail nature of workers' compensation and significant uncertainty regarding the ultimate results of reforms to the California workers' compensation market. These calculations resulted in a fair value estimate that was not materially different from the historical undiscounted net loss reserves.

#### 4. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Bank deposits	\$ 14,524	\$ 14,372
Corporate notes and commercial paper	30,704	30,188
Money market funds	<u>136,229</u>	<u>151,155</u>
Total	<u>\$ 181,457</u>	<u>\$ 195,715</u>

## 5. INVESTMENTS

The components of net investment and other income for the years ended December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Interest and dividend income:		
Debt securities	\$ 75,565	\$ 63,287
Short-term investments	4,313	6,763
Cash equivalents		875
Equity securities	<u>2,849</u>	<u>3,253</u>
Total interest and dividend income	82,727	74,178
Rental and other income	<u>2,437</u>	<u>1,481</u>
Gross investment income	85,164	75,659
Investment expenses	<u>(3,096)</u>	<u>(3,907)</u>
Net investment and other income	<u><u>\$ 82,068</u></u>	<u><u>\$ 71,752</u></u>

Net gains (losses) included in operations and net changes in unrealized (losses) gains included in other comprehensive (loss) income for the years ended December 31, 2008 and 2007, are summarized as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Net investment (losses) gains:		
Debt securities:		
Net loss on the transfer of available-for-sale securities to trading securities	\$ -	\$ (6,576)
Available for sale:		
Net realized gains (losses) on sale of available-for-sale debt securities	7,392	(5,052)
Impairment loss on available-for-sale debt securities	(13,838)	
Trading securities:		
Net realized losses on sale of trading debt securities	(4,695)	
Net realized losses on holding of trading debt securities	(47,441)	
Equity securities:		
Net gains on the transfer of available-for-sale securities to trading securities		24,886
Available for sale — Net realized gains on sale of available-for-sale equity securities		29,001
Trading securities:		
Net realized losses on sale of trading equity securities	(23,028)	
Net realized losses on holding of trading equity securities	(66,492)	
Other invested assets	(968)	(1,285)
Net investment (losses) gains	<u>(149,070)</u>	<u>40,974</u>
Net changes in unrealized losses on available-for-sale investments:		
Debt securities	(17,130)	15,718
Equity securities	(15,954)	(18,318)
Other		(27)
	<u>(33,084)</u>	<u>(2,627)</u>
Net realized investment (losses) gains and changes in unrealized losses on investments	<u>\$ (182,154)</u>	<u>\$ 38,347</u>

A summary of the disposition through sale or call of debt securities and equity securities for the years ended December 31, 2008 and 2007, is as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Proceeds from sales of investment securities	<u>\$2,867,239</u>	<u>\$3,240,610</u>
Gross gains on sales of investment securities	45,085	49,939
Gross losses on sales and impairment of investment securities	<u>(79,254)</u>	<u>(25,990)</u>
Net realized (losses) gains	<u>\$ (34,169)</u>	<u>\$ 23,949</u>

The following table summarizes the Company's investments measured at fair value on a recurring basis at December 31, 2008 (there were no investments measured at fair value on a non-recurring basis as of December 31, 2008):

	<u>Fair Value Measurements Using</u>			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value
Trading securities	\$ 455,309	\$ 55,731	\$ -	\$ 511,040
Available-for-sale securities	<u>995,686</u>	<u>52,716</u>	<u>          </u>	<u>1,048,402</u>
Total	<u>\$1,450,995</u>	<u>\$108,447</u>	<u>\$ -</u>	<u>\$1,559,442</u>

Investments in available-for-sale securities as of December 31, 2008 and 2007, consist of the following (in thousands):

	<u>2008</u>			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities — available-for-sale:				
Debt securities, including short-term investments:				
U.S. government and agency securities	\$ 252,612	\$28,301	\$ -	\$ 280,913
Asset-backed securities and collateralized mortgage obligations	343,146	11,434	(10,983)	343,597
Corporate notes and commercial paper	<u>421,063</u>	<u>1,992</u>	<u>(26,887)</u>	<u>396,168</u>
Total debt securities, including short-term investments	1,016,821	41,727	(37,870)	1,020,678
Equity securities	<u>42,835</u>	<u>          </u>	<u>(15,111)</u>	<u>27,724</u>
Total marketable securities — available for sale	<u>\$1,059,656</u>	<u>\$41,727</u>	<u>\$(52,981)</u>	<u>\$1,048,402</u>

	<b>2007</b>			
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
Marketable securities — available-for-sale:				
Debt securities, including short-term investments:				
U.S. government and agency securities	\$ 310,007	\$ 12,259	\$ (22)	\$ 322,244
Asset-backed securities and collateralized mortgage obligations	423,348	7,627	(170)	430,805
Corporate notes and commercial paper	207,998	2,577	(1,598)	208,977
Certificates of deposit	514			514
Municipal bonds	<u>50,315</u>	<u>295</u>	<u>(2)</u>	<u>50,608</u>
Total debt securities, including short-term investments	992,182	22,758	(1,792)	1,013,148
Equity securities	<u>29,101</u>	<u>1,045</u>	<u>(181)</u>	<u>29,965</u>
Total marketable securities — available for sale	<u>\$1,021,283</u>	<u>\$23,803</u>	<u>\$ (1,973)</u>	<u>\$1,043,113</u>

Gross unrealized gains and losses as of December 31, 2008 and 2007, less applicable deferred income taxes, on available-for-sale securities are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Unrealized gains	\$ 41,727	\$ 23,803
Unrealized losses	<u>(52,981)</u>	<u>(1,973)</u>
Net unrealized (losses) gains	(11,254)	21,830
Deferred income tax benefit (expense)	<u>3,939</u>	<u>(7,640)</u>
Net unrealized (losses) gains on available-for-sale investments	<u>\$ (7,315)</u>	<u>\$ 14,190</u>

The amortized cost and estimated fair value of bonds, notes, and other securities held at December 31, 2008, by contractual maturity are shown below (in thousands). Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<b>Amortized Cost</b>	<b>Fair Value</b>
Available for sale:		
Due in one year or less	\$ 8,173	\$ 8,183
Due after one year through five years	380,072	385,956
Due after five years through ten years	254,863	253,219
Due after ten years	<u>25,787</u>	<u>24,957</u>
Total available for sale	668,895	672,315
Asset-backed securities and collateralized obligations	<u>347,926</u>	<u>348,363</u>
Total	<u><u>1,016,821</u></u>	<u><u>1,020,678</u></u>

The aggregate fair values of available-for-sale investments, by asset category, in unrealized loss position at December 31, 2008 and 2007, are shown below (in thousands):

	<b>2008</b>			
	<b>12 Months or Less</b>		<b>Greater Than 12 Months</b>	
	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>
U.S. government and agency securities	\$ -	\$ -	\$ -	\$ -
Asset-backed securities and collateralized mortgage obligations	10,948	30,003	35	49
Corporate notes and commercial paper	22,894	343,008	3,993	16,664
Municipal securities				
Equity securities	<u>15,111</u>	<u>27,574</u>	<u>      </u>	<u>      </u>
Total available-for-sale securities	<u>\$ 48,953</u>	<u>\$400,585</u>	<u>\$4,028</u>	<u>\$ 16,713</u>
	<b>2007</b>			
	<b>12 Months or Less</b>		<b>Greater Than 12 Months</b>	
	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>
U.S. government and agency securities	\$ 22	\$ 19,259	\$ -	\$ -
Asset-backed securities and collateralized mortgage obligations	170	24,457		
Corporate notes and commercial paper	1,598	69,825		
Municipal securities	2			
Equity securities	<u>181</u>	<u>3,778</u>	<u>      </u>	<u>      </u>
Total available-for-sale securities	<u>\$ 1,973</u>	<u>\$117,319</u>	<u>\$ -</u>	<u>\$ -</u>

As of December 31, 2008, we have the ability to hold the investments included in the table above for the foreseeable future and have the intent to hold the investments and monitor the existing unrealized loss as well as any additional losses through recovery. At future evaluation points we will again consider available evidence to evaluate potential impairment of investments and determine, whether the impairment is other than temporary. At that time, we will also determine whether we should sell the securities or continue to hold them in the investment portfolio and record an impairment charge.

In the normal course of business, we enter into securities lending agreements with various counterparties. Under these agreements, we lend United States securities in exchange for collateral consisting of government-sponsored agency securities and in turn receive a nominal fee. These agreements are primarily overnight in nature and settle the next business day. The carrying value of securities and collateral involved in these arrangements as of December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Securities	\$ 106,929	\$ 329,895
Collateral balance	109,856	337,165

United States government securities with carrying values at December 31, 2008 and 2007, of \$146,947,356 and \$14,037,725, respectively, were on deposit with regulatory authorities.

Other invested assets, which are included in "Other assets" on the balance sheets as of December 31, 2008, include the following (in thousands):

	<b>Carrying Value</b>
Investments in limited partnerships	\$ 4,378
79,868 shares of BCS Insurance	4,526
34,259 shares of Federal Home Loan Bank of Indianapolis	3,426
Investment in Trust I	<u>619</u>
Total	<u>\$ 12,949</u>

The investments shown in the table above are not readily marketable. As a result, we periodically review available financial and other information to determine whether they have suffered any impairment in value. We report adjustments to the carrying value as a component of operations during the year.

## 6. PROPERTY AND EQUIPMENT

Property and equipment as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Land and improvements	\$ 4,988	\$ 6,751
Buildings and improvements	47,871	24,381
Furniture and equipment	20,252	20,621
Software	<u>38,196</u>	<u>27,221</u>
Total	111,307	78,974
Less accumulated depreciation	<u>(42,259)</u>	<u>(33,596)</u>
Net property and equipment	<u>\$ 69,048</u>	<u>\$ 45,378</u>
Net property and equipment — occupied and/or used by the Company	\$ 60,253	\$ 35,947
Net property — held for production of income	<u>8,795</u>	<u>9,431</u>
Total	<u>\$ 69,048</u>	<u>\$ 45,378</u>

Depreciation expense for the years ended December 31, 2008 and 2007, was \$9,185,977 and \$7,144,557, respectively.

During 2008 and 2007, we reviewed our real estate holdings for possible impairment in value. As a result of that review, as of December 31, 2008 and 2007, we have written down the carrying value on certain properties by a total of \$0 and \$3,067,732, respectively.

## 7. GOODWILL AND INTANGIBLE ASSETS

Acquisitions are accounted for under the purchase method of accounting and, accordingly, the purchase price is allocated to assets acquired and liabilities assumed based on their estimated fair values. The excess of cost over the fair value of net assets acquired is recorded as goodwill. The purchase price for CWIH in 2007 was initially recorded based on best estimates. Those values were finalized by third party valuation experts in 2008, resulting in appropriate changes in asset values and lives.

We annually evaluate recorded goodwill and indefinite lived intangible assets for impairment. We completed our annual impairment tests as of December 31, 2008 and 2007, and no impairment was deemed necessary. Goodwill and intangible assets as of December 31, 2008 and 2007, consist of the following (in thousands):

	Useful Life	2008		
		Initial Value	Accumulated Amortization	Carrying Value
Goodwill:				
Assets acquired — net of liabilities assumed — in 1994	Indef.	\$ 101,520	\$ 47,376	\$ 54,144
Acquisition of CWIH in 2007	Indef.	35,778		35,778
Acquisition of UWIC in 2005	Indef.	<u>24,738</u>		<u>24,738</u>
Total		162,036	47,376	114,660
Intangible assets:				
Broker network	20 yrs	19,700	1,222	18,478
Trade names	Indef.	7,400		7,400
Customer base	1 yr	3,900	3,900	0
Covenant not to compete	3 yrs	900	331	569
State licenses	Indef.	<u>120</u>		<u>120</u>
Total		32,020	5,453	26,567
Net goodwill and intangible assets		<u>\$ 194,056</u>	<u>\$ 52,829</u>	<u>\$ 141,227</u>

	Useful Life	2007		
		Initial Value	Accumulated Amortization	Carrying Value
Goodwill:				
Assets acquired — net of liabilities assumed — in 1994	Indef.	\$ 101,520	\$47,376	\$ 54,144
Acquisition of UWIC in 2005	Indef.	<u>24,738</u>		<u>24,738</u>
Total		126,258	47,376	78,882
Goodwill and intangible assets:				
Acquisition of CWIH in 2007	TBD	<u>59,994</u>		<u>59,994</u>
Total		59,994	-	59,994
Net goodwill and intangible assets		<u>\$186,252</u>	<u>\$47,376</u>	<u>\$138,876</u>

Amortization expense for the years ended December 31, 2008 and 2007, was \$5,452,712 and \$0, respectively.

Future expected amortization expense is as follows in (thousands):

**Years Ending  
December 31**

2009	\$ 1,261
2010	1,253
2011	973
2012	973
2013	973
Thereafter	<u>13,614</u>
Total	<u>\$ 19,047</u>

**8. LOSSES AND LOSS ADJUSTMENT EXPENSES**

Activity in the reserves for losses and loss adjustment expenses for the years ended December 31, 2008 and 2007, is summarized as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Balance — January 1	\$ 1,337,459	\$ 1,236,179
Less reinsurance recoverable	<u>247,165</u>	<u>246,286</u>
Net balance — January 1	<u>1,090,294</u>	<u>989,893</u>
Incurred related to:		
Current	597,573	452,172
Prior years	<u>2,710</u>	<u>8,736</u>
Total	<u>600,283</u>	<u>460,908</u>
Paid related to:		
Current	189,487	124,522
Prior years	<u>399,329</u>	<u>316,213</u>
Total	<u>588,816</u>	<u>440,735</u>
Unpaid loss and loss adjustment expense assumed through acquisition of CWIH and TCIC — net of reinsurance	<u>                    </u>	<u>80,228</u>
Net balance — December 31	1,101,761	1,090,294
Plus reinsurance recoverables	<u>204,405</u>	<u>247,165</u>
Balance — December 31	<u>\$ 1,306,166</u>	<u>\$ 1,337,459</u>

The provision for prior years' losses and loss adjustment expenses, net of reinsurance recoveries, increased by approximately \$2.7 million and \$8.7 million in 2008 and 2007, respectively. The increase in 2008 was mainly due to several large losses and rising medical loss trends. The increase in 2007 was primarily due to adverse loss development patterns on Michigan losses from accident years 1999 through 2004. We did not have to accrue additional premiums or return premiums as a result of the prior year effects.

## 9. OTHER ASSETS

Other assets as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Other invested assets	\$ 12,949	\$ 24,736
Accrued investment income	15,339	14,403
Deferred policy acquisition costs	40,197	39,715
Prepaid reinsurance premiums	8,537	8,752
Other prepaid expenses	3,912	4,197
Funds held by others	205	1,210
Federal income tax recoverable	17,868	2,550
Other	<u>6,794</u>	<u>6,878</u>
Total	<u>\$ 105,801</u>	<u>\$ 102,441</u>

## 10. PREMIUMS RECEIVABLE

Premiums receivable as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Premiums in course of collection	\$ 63,633	\$ 70,677
Future installments not yet billed	250,407	235,900
Accrued retrospective premiums	2,793	2,081
Earned but unbilled premiums	<u>16,108</u>	<u>20,336</u>
Total	332,941	328,994
Allowance for uncollectible premiums	<u>(4,935)</u>	<u>(4,840)</u>
Premiums receivable — net	<u>\$ 328,006</u>	<u>\$ 324,154</u>

## 11. NOTES PAYABLE AND JUNIOR SUBORDINATED DEBT

In 2008, we entered into a long-term financing arrangement with the Federal Home Loan Bank of Indianapolis (FHLBI) to provide funding for the construction of our new corporate headquarters. The initial borrowings under this arrangement were \$25 million on October 7, 2008, and \$25 million on October 16, 2008. As of December 31, 2008, the total outstanding debt was \$49,758,100 and is collateralized by \$72,302,173 of available-for-sale bonds held in a segregated trust account at Comerica Bank. In addition to the above, on January 20, 2009, we borrowed an additional \$75 million from FHLBI for further funding on the new headquarters.

Interest is due on the 15th of every month with final payments due on October 10, 2028, for the first loan, October 16, 2028, for the second loan, and January 20, 2014, for the third loan. The interest rate for the three loans are 4.81%, 5.53%, and 2.67%, respectively. Interest paid and accrued on outstanding debt for 2008 amounted to \$581,779.

In 2006, before its acquisition by the Company, CWIH arranged for the sale of \$20 million of trust preferred securities through Trust I. Trust I was created solely for the purpose of issuing the trust preferred securities. In accordance with FIN No. 46(R), we have not consolidated Trust I into these financial statements.

CWIH purchased all of the outstanding stock of Trust I for \$619,000, and that investment in Trust I is included in other assets in the consolidated balance sheets. Trust I used the \$20,619,000 proceeds from the sale of the trust preferred securities and common stock to purchase the floating rate junior subordinated debentures (the junior subordinated debt) issued to Trust I under an indenture. The junior subordinated debt is the sole asset of Trust I, and the trust preferred securities are the sole liabilities of Trust I.

The following table summarizes the nature and terms of the junior subordinated debt and trust preferred securities:

Issue date	June 15, 2006
Principal amount of trust preferred securities	\$20,000,000
Principal amount of junior subordinated debt	\$20,619,000
Maturity date of junior subordinated debt — unless accelerated earlier	June 15, 2036
Trust common stock	\$ 619,000
Interest rate — per annum ending on (but excluding) the interest payment date in June 2011	9.045 %
Interest rate — per annum for each subsequent period	Three-month LIBOR plus 3.6%
Redeemable at 100% of principal amount at option of CWIH on or after	June 15, 2011

Interest on the trust preferred securities and interest paid by CWIH to Trust I on the junior subordinated debt is payable quarterly in arrears. Through December 31, 2008, interest accrued at a rate of 9.045% and totaled \$1,864,989. We have the right, which we have not exercised, to defer interest payment on the junior subordinated debt for up to five years without triggering an event of default.

The trust preferred securities are subject to mandatory redemption in a like amount (a) upon repayment of all the junior subordinated debt on the stated maturity date, (b) contemporaneously with optional prepayment of all the junior subordinated debt by CWIH in conjunction with a special event (as defined), and (c) five years or more after the issue date, contemporaneously with the optional prepayment, in whole or in part, of the junior subordinated debt.

CWIH has provided a full, irrevocable, and unconditional guarantee of payments of amounts due on the trust preferred securities. The indenture contains certain covenants with which CWIH is in compliance as of December 31, 2008. Interest payable is included in accrued expenses on the accompanying consolidated balance sheets.

Future minimum payments required on outstanding debt as of December 31, 2008, is as follows in (thousands)

2009	\$ 4,689
2010	5,673
2011	6,139
2012	5,742
2013	5,326
Thereafter	<u>64,286</u>
Total minimum payments	91,855
Less amount representing interest	<u>(21,478)</u>
Total debt	<u>\$ 70,377</u>

## 12. OTHER LIABILITIES

Other liabilities as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Accrued commissions	\$ 18,127	\$ 23,463
Accrued expenses	7,618	9,241
Accrued employee expenses	15,889	15,177
Accrued pensions	17,414	8,371
Accrued postretirement benefits	12,040	10,778
Policyholder dividends	44,695	45,766
Overdraft checks	22,005	26,230
Reinsurance premium payable — residual market retrocession	7,750	5,224
Assumed paid losses — residual markets	7,258	6,292
Other liabilities	<u>17,161</u>	<u>19,550</u>
Total	<u>\$ 169,957</u>	<u>\$ 170,092</u>

The carrying value and estimated fair value of the Company's debt was \$70,377,100 and \$72,437,000, respectively at December 31, 2008 and \$20,619,000 and \$20,731,000, respectively, at December 31, 2007.

## 13. REINSURANCE

In the ordinary course of business, we enter into reinsurance contracts, also known as treaties, whereby the Company and its subsidiaries assume and cede premiums and losses with other insurance companies. These arrangements serve to limit the maximum net loss on catastrophes. We also participate as a reinsurer in various residual market workers' compensation pools. Participation in these pools is mandatory in many states in which we conduct business, and thus the pools are frequently referred to as involuntary pools. Involuntary pool underwriting results generally are distributed to companies writing workers' compensation insurance in each state based upon each company's market share of the total voluntary workers' compensation market.

Reinsurance does not relieve us of our primary obligations under our contracts of insurance. To the extent our reinsurers are unable or unwilling to honor their obligations under the reinsurance treaties, we remain primarily liable to our policyholders. To manage this risk, we periodically evaluate the financial condition of our reinsurers. When needed, we establish allowances for uncollectible reinsurance recoverables.

The effects of reinsurance activities on premiums and losses for the years ended December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Written premiums:		
Direct	\$ 873,515	\$ 739,944
Reinsurance assumed	31,744	29,411
Reinsurance ceded	<u>(28,001)</u>	<u>(44,744)</u>
Net premiums written	<u>\$ 877,258</u>	<u>\$ 724,611</u>
Earned premiums:		
Direct	\$ 855,889	\$ 723,805
Reinsurance assumed	32,631	33,015
Reinsurance ceded	<u>(28,828)</u>	<u>(57,894)</u>
Net premiums earned	<u>\$ 859,692</u>	<u>\$ 698,926</u>
Losses and loss adjustment expenses incurred:		
Direct	\$ 585,818	\$ 489,544
Reinsurance assumed	18,205	21,116
Reinsurance ceded	<u>(3,740)</u>	<u>(49,752)</u>
Net losses and loss adjustment expenses incurred	<u>\$ 600,283</u>	<u>\$ 460,908</u>

Reinsurance recoverables and prepaid reinsurance as of December 31, 2008 and 2007, consist of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Reinsurance recoverables:		
Unpaid losses recoverable on workers' compensation policies	\$ 181,569	\$ 218,617
Unpaid losses recoverable on disability policies	22,836	28,548
Accrued reinsurance premiums recoverable and other	6,999	14,842
Paid losses recoverable	<u>21,968</u>	<u>21,447</u>
Total	<u>\$ 233,372</u>	<u>\$ 283,454</u>
Total prepaid reinsurance	<u>\$ 8,537</u>	<u>\$ 8,752</u>

#### 14. FEDERAL INCOME TAXES

The Company and all its subsidiaries are included in the consolidated federal income tax return of BCBSM. Current taxes are allocated between the Company and BCBSM and between the Company and its subsidiaries according to written tax-sharing agreements. Under these agreements, income taxes allocated to each company are equivalent to the liability it would have incurred had it filed a separate return. Federal income taxes of \$17,867,729 and \$2,550,118 were recoverable from BCBSM as of December 31, 2008 and December 31, 2007, respectively.

The significant components of federal income tax (benefit) expense for the years ended December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Current	\$ 35,761	\$ 44,253
Deferred	<u>(53,808)</u>	<u>6,931</u>
Total	<u>\$ (18,047)</u>	<u>\$ 51,184</u>

The tax effects of the temporary differences giving rise to the deferred tax assets and liabilities as of December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Deferred income tax assets:		
Discount of liability for losses and loss adjustment expenses	\$ 60,714	\$ 58,021
Unearned premiums	28,728	31,118
Net realized and unrealized losses on investment securities	37,949	
Pension and postretirement benefits	10,255	6,363
Policyholder dividends	11,440	7,676
Goodwill	5,166	5,602
Guaranty fund assessments	1,470	4,551
Net operating loss carryovers of TCIC	7,927	7,779
Other	8,386	4,112
Allowance	<u>(7,927)</u>	<u>(7,779)</u>
Total deferred income tax assets — net of allowance	<u>164,108</u>	<u>117,443</u>
Deferred income tax liabilities:		
Net unrealized gains on investment securities		8,469
Property and equipment	3,606	1,431
Deferred policy acquisition costs	14,069	13,922
Intangible assets	9,299	
Other	<u>726</u>	<u>16,362</u>
Total deferred income tax liabilities	<u>27,700</u>	<u>40,184</u>
Net deferred income tax assets	<u>\$ 136,408</u>	<u>\$ 77,259</u>

The provision for income taxes differs from the amount computed by applying the United States statutory income tax rate of 35% to income before taxes as of December 31, 2008 and 2007, for the following reasons (in thousands):

	<b>2008</b>	<b>2007</b>
Tax provision at statutory rate	\$ (17,079)	\$ 51,973
Tax effect of:		
Dividends received exclusion	(557)	(697)
Extraordinary gain		(300)
Realized value of net operating loss carryover of TCIC	(171)	(75)
Other	<u>(240)</u>	<u>283</u>
Provision for income taxes	<u>\$ (18,047)</u>	<u>\$ 51,184</u>
Effective tax rate	<u>37 %</u>	<u>34 %</u>

At December 31, 2008, approximately \$22,650,000 of tax loss carryforwards, which will begin to expire in 2016, were available to offset future taxable income in TCIC. The realization of this benefit is in doubt, and, as a result, we have recorded an allowance for the full amount of the benefit.

## 15. EMPLOYEE BENEFITS

Our employees participate in several employee benefit plans, several of which are sponsored by BCBSM. We maintain separate records and accounting for the shares of these plans that pertain to our employees. In 2008, we recorded the impact of the change in our measurement date from September 30 to December 31 as required by FASB Statement No. 158 for each of our pension and postretirement benefit plans using the Remeasurement Method.

**Defined Contribution Plan** — Substantially, all employees who meet age and service requirements may participate in a 401(k) plan. Except for employees of CompWest, we match 50% of employee contributions up to 10% of bi-weekly adjusted wages. Employees of CompWest may receive a profit sharing contribution from CompWest to their 401(k) accounts. Total 401(k) expenses for the years ended December 31, 2008 and 2007, were \$1,590,982 and \$1,377,701, respectively.

**Retirement Account Plan** — Certain employees who meet age and service requirements and who are not members of a labor union participate in a defined benefit plan that provides participants an account balance to which interest credits and earnings credits are added. Employees can elect to receive the lump-sum value of their account balance when they retire or leave employment, or they can receive monthly payments at retirement. The Company contributions during the years ended December 31, 2008 and 2007, totaled \$2,483,817 and \$0, respectively.

**Defined Benefit Plan** — Employees who meet age and service requirements and who are members of a labor union participate in a defined benefit plan in which benefits are based on final compensation and credited service at the date of retirement or termination. We make annual contributions sufficient to meet the minimum funding standards of the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986. No contributions to the plan were required during 2008 and 2007.

**Other Postretirement Benefits** — We provide postretirement health care and other benefits to some of our employees who meet service and age requirements. The benefits for qualified employees not represented by a labor union are subject to revision at the discretion of the Board of Directors. Postretirement benefits for employees who are represented by a labor union are subject to collective bargaining agreements.

The following table shows the pension funded status at the plan measurement date of December 31, 2008 and September 30, 2007, for the Retirement Account Plan and the Defined Benefit Plan (in thousands):

	<b>2008</b>	<b>2007</b>
Accumulated benefit obligation	\$ 27,979	\$ 24,153
Effect of estimated future pay increases	<u>5,141</u>	<u>4,761</u>
Projected benefit obligation	<u>33,120</u>	<u>28,914</u>
Plan assets at fair market value	<u>15,706</u>	<u>21,174</u>
Plan assets less than projected benefit obligation	17,414	7,740
Prepaid pension expense included in other assets	<u>        </u>	<u>631</u>
Accrued pension obligations included in other liabilities	<u>\$ 17,414</u>	<u>\$ 8,371</u>

The discount rates used in determining the actuarial present value of the projected benefit obligations range from 6.75% to 6.9% at December 31, 2008, and 5.9% to 6.1% at September 30, 2007. Assumed rates of increase in future compensation for both years range from approximately 3% to 6.5%, depending on the ages of the participants.

The expected long-term rate of return on assets was 9% for 2008 and 2007. When selecting long-term rates of return, we consider various criteria, including historical returns and the asset allocation policy of the pension plan.

The following table sets forth the current period benefit costs, employer contributions, benefits paid, and other changes to the Retirement Account Plan and the defined benefit plan for the years ended December 31, 2008 and 2007 (in thousands):

	<b>2008</b>	<b>2007</b>
Service cost	\$ 2,870	\$ 2,896
Interest cost on projected benefit obligation	1,907	1,572
Expected return on assets	(1,736)	(1,342)
Net amortization and deferral	<u>31</u>	<u>109</u>
Net periodic pension cost	<u>\$ 3,072</u>	<u>\$ 3,235</u>
Employer contributions	<u>\$ 2,484</u>	<u>\$ -</u>
Benefits paid	<u>\$ 1,333</u>	<u>\$ 919</u>

The one-time impact of changing the measurement date from September 30 to December 31, recorded as an adjustment to retained earnings, is as follows (in thousands):

Service cost	\$ 763
Interest cost	460
Expected return on assets	(374)
Amortization of net prior service cost	(10)
Amortization of net loss	<u>23</u>
 Net periodic pension cost	 <u>\$ 862</u>

Weighted-average target asset allocation and actual asset allocations at December 31, 2008 and 2007, by asset category are as follows:

	<b>Target</b>	<b>2008</b>	<b>2007</b>
Asset category:			
Equity securities	70.0 %	64.0 %	72.0 %
Debt securities	25.0	32.0	26.0
Other — cash	<u>5.0</u>	<u>4.0</u>	<u>2.0</u>
 Total	 <u>100.0 %</u>	 <u>100.0 %</u>	 <u>100.0 %</u>

The retirement plans have an asset allocation policy based on objectives, retirement plan characteristics, capital market expectations, and asset-liability projections. The policy is long-term oriented and consistent with our risk posture. The retirement plans use a mix of core and satellite managers to implement the asset allocation policy. The asset mix is reviewed on a periodic basis, and the portfolio is reallocated any time there is a material deviation in the asset class as described in the allocation policy. The policy includes a target allocation as included in the table above and a range of plus or minus 3% of the target established. Asset allocations are currently outside of the permitted variances due to the fact that market value reductions on equity securities exceed those on debt securities in 2008. The Company will rebalance pension asset allocations as provided in the guidelines as market conditions allow.

Long-term rates of return for the retirement plans are determined using various criteria. Asset class, historical returns, assumptions for future returns, and other factors lend to this determination.

The retirement plan benefits as of December 31, 2008, expected to be paid in each of the next five years and in the aggregate for the five years thereafter, are as follows (in thousands):

2009	\$ 1,310
2010	1,490
2011	1,640
2012	2,190
2013	2,290
2014 through 2018	<u>15,790</u>
 Total	 <u>\$ 24,710</u>

We do not expect to contribute to the retirement plans during 2009.

The amounts recognized in the balance sheets at December 31, 2008 and 2007, and the amounts in accumulated other comprehensive loss that have not yet been recognized as components of net periodic benefit cost are as follows:

	<b>2008</b>	<b>2007</b>
<b>Balance Sheets</b>		
Pension assets in other assets	\$ -	\$ 429
Pension liabilities in other liabilities	<u>(17,414)</u>	<u>(8,371)</u>
Total balance sheet liabilities	<u>\$ (17,414)</u>	<u>\$ (7,942)</u>
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Net actuarial gain (loss)	10,194	(395)
Net prior service cost (credit)	26	(23)
Other	(2,564)	(137)
Deferred income tax (expense) benefit	<u>(2,679)</u>	<u>194</u>
Total accumulated other comprehensive income (loss)	<u>\$ 4,977</u>	<u>\$ (361)</u>

We expect to recognize the following as components of net periodic benefit cost in 2009 (in thousands):

Amortization of prior service credit	\$ (40)
Amortization of net losses	<u>60</u>
Total amortization expected to be recognized	<u>\$ 20</u>

The accumulated obligation for employee postretirement benefits attributable to active and eligible employees at the December 31, 2008 and September 30, 2007, measurement dates and the amount recognized in the consolidated financial statements at December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Accumulated postretirement benefit obligation	\$ 12,088	\$ 10,039
Other adjustments	399	3,554
Unrecognized prior service costs (credits)	114	(302)
Unrecognized accumulated net gain	<u>(561)</u>	<u>(2,513)</u>
Accrued postretirement benefit liability included in other liabilities	<u>\$ 12,040</u>	<u>\$ 10,778</u>

Net postretirement benefit costs for the years ended December 31, 2008 and 2007, include the following components:

	<b>2008</b>	<b>2007</b>
Service cost	\$ 922	\$ 1,069
Interest cost	701	603
Net amortization and deferral	<u>(91)</u>	<u>(11)</u>
Net postretirement benefit costs	<u>\$ 1,532</u>	<u>\$ 1,661</u>

The one-time impact of changing the measurement date from September 30 to December 31, recorded as an adjustment to retained earnings, is as follows (in thousands):

Service cost	\$ 245
Interest cost	172
Amortization of net prior service cost	(23)
Amortization of net loss	<u>5</u>
Net periodic postretirement cost	<u>\$ 399</u>

For 2008 measurement purposes, the health care trend rate on covered charges is assumed to be 7.75% for 2008, adjusting downward ratably to 5% in 2015, and remaining at that level thereafter. For 2007 measurement purposes, the health care trend rate on covered charges is assumed to be 8.14% for 2007, adjusting downward ratably to 5% in 2015, and remaining at that level thereafter. The discount rate used in determining the actuarial present value of the accumulated postretirement obligation was 6.0% at December 31, 2008 and September 30, 2007.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was signed into law. The Act provides a prescription drug benefit under Medicare ("Medicare Part D") as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least equivalent to the Medicare Part D benefit.

In 2004, we adopted FSP FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. We determined that the prescription drug benefits provided by the Company's postretirement health care plan are actuarially equivalent to the Medicare Part D and, accordingly, entitled us to the federal subsidy described in the Act. We measured the effects of the Act on the accumulated postretirement benefit obligation (APBO) and net periodic postretirement benefit cost on September 30, 2008. The APBO decreased by \$497,651 for the subsidy related to benefits attributed to past service. The aggregate effect on service cost, interest cost, and amortization of gains and losses resulted in a reduction of \$101,621 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.

The postretirement health care plan is unfunded and, as such, held no assets and had no asset allocations as of December 31, 2008 or 2007. Benefits are funded as incurred.

The expected future benefit payments and anticipated federal subsidies recoverable at December 31, 2008, are as follows (in thousands):

	<b>Future Benefit Payments</b>	<b>Anticipated Future Subsidies</b>
2009	\$ 350	\$ (10)
2010	400	(10)
2011	500	(10)
2012	590	(30)
2013	690	(60)
2014 through 2018	<u>4,940</u>	<u>(320)</u>
Total	<u>\$ 7,470</u>	<u>\$ (440)</u>

Health care benefit payments are estimates using the current actuarially assumed growth rates. These estimates are dependent upon various factors, including demographics and inflation. The above estimates are based upon the assumption that participant demographics remain unchanged.

The amounts recognized in the balance sheets at December 31, 2008 and 2007, and the amounts in accumulated other comprehensive loss that have not yet been recognized as components of net periodic benefit cost are as follows:

	<b>2008</b>	<b>2007</b>
<b>Balance Sheets</b>		
Other assets	\$ -	\$ -
Postretirement liabilities in other liabilities	<u>(12,040)</u>	<u>(10,778)</u>
Total	<u>\$ (12,040)</u>	<u>\$ (10,778)</u>
<b>Accumulated Other Comprehensive Loss</b>		
Net actuarial gain	\$ 1,083	\$ 1,645
Net prior service credit	(792)	(906)
Deferred income taxes	<u>(103)</u>	<u>(259)</u>
Total	<u>\$ 188</u>	<u>\$ 480</u>

We expect to recognize the following as components of net periodic benefit cost in 2009 (in thousands):

Amortization of prior service credit	\$ (90)
Amortization of net losses	<u>10</u>
Total amortization expected to be recognized	<u>\$ (80)</u>

## 16. LEASES

We lease office space, office equipment, software, parking spaces, and storage under several operating leases expiring on various dates through the year 2013. Rental expense for 2008 and 2007 was \$2,377,691 and \$1,548,229, respectively. Future minimum lease payments as of December 31, 2008, are as follows (in thousands):

2009	\$ 1,742
2010	1,215
2011	1,323
2012	1,266
2013	574
Thereafter	<u>          </u>
Total	<u>\$ 6,120</u>

The Company is the lessor of parking facilities with rental income for the years ended December 31, 2008 and 2007, totaling \$389,581 and \$419,316, respectively.

## 17. SERVICE AGREEMENTS

We have entered into certain noncancelable agreements with service providers. Future noncancelable commitments under these service agreements as of December 31, 2008, are as follows in (thousands):

2009	\$ 1,736
2010	1,755
2011	1,407
2012	1,008
2013	691
Thereafter	<u>403</u>
Total	<u>\$ 7,000</u>

## 18. RELATED-PARTY TRANSACTIONS

We have entered into an agreement whereby the Company and BCBSM may provide services to one another. The agreement provides for monthly payments and a year-end settlement based on actual cost of services performed. During 2008 and 2007, BCBSM supplied executive, legal, financial, and other services to the Company at a cost of \$1,429,517 and \$2,224,004, respectively.

We also purchase health care insurance benefits, some of which we self insure, for some of our employees from BCBSM and its subsidiary Blue Care Network (BCN). Total expenses paid for administration of self-insured benefits were \$321,236 and \$190,076 in 2008 and 2007, and total self-insured health care benefits reimbursed to BCBSM were \$8,222,576 and \$4,223,907 in 2008 and 2007, respectively. Total premiums paid were \$2,366,223 and \$2,042,856 in 2008 and 2007, respectively.

We sell workers' compensation insurance and services and short-term disability administration services to BCBSM and BCN. The administrative fees and insurance premiums paid by BCBSM and BCN during 2008 and 2007 were \$1,321,107 and \$1,170,674, respectively.

## 19. COMMITMENTS AND CONTINGENCIES

We are involved in numerous lawsuits arising in the normal course of administering our workers' compensation business. In our opinion, we have made adequate provisions for the costs of resolving those matters in the loss and loss adjustment expense reserves or, based on the advice of legal counsel, we believe the matters will be resolved without material adverse effect on the Company's consolidated financial position or results of operations.

We have entered into an agreement with a developer to construct a new corporate headquarters building for the Company in Lansing, Michigan. As of December 31, 2008, the Company has loaned approximately \$25 million to a development company created by the developer solely to provide for the construction of the new corporate headquarters and has committed to provide funds to complete the construction project. We estimate the remaining amount to fund the project to completion is approximately \$105 million. As noted in footnote 2, we have recognized the amounts loaned as construction in progress in the consolidated financial statements under property and equipment.

## 20. INSURANCE-RELATED ASSESSMENTS

The liabilities and anticipated payment schedules for the guaranty fund and other insurance-related assessments recorded as of December 31, 2008 and 2007, are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Payable in one year or less	\$ 19,018	\$ 22,119
Payable after one year through five years	4,134	5,816
Payable after five years through 10 years	1,511	1,473
Payable after 10 years	<u>2,084</u>	<u>2,031</u>
Total insurance-related assessments	26,747	31,439
Other taxes and fees	<u>3,300</u>	<u>4,440</u>
Total assessments, taxes, and fees payable	<u>\$ 30,047</u>	<u>\$ 35,879</u>
Federal income tax recoverable	<u>\$ 17,868</u>	<u>\$ 2,550</u>

No anticipated premium tax offsets were available to reduce liabilities recorded at December 31, 2008 and 2007.

Adjustments to accruals for guaranty fund assessments of \$(2,971,199) and \$5,622,493 were charged to operations during 2008 and 2007, respectively. We expect to pay guaranty fund assessments in 2009, based upon the 2008 written premium, and have recorded liabilities totaling \$8,212,556 as of December 31, 2008.

## 21. STATUTORY ACCOUNTING AND DIVIDEND RESTRICTIONS

State insurance regulatory authorities require us to file statutory financial statements for the Company and each of its insurance subsidiaries. GAAP differs from statutory accounting practices prescribed or permitted by regulatory authorities. Differences between financial statement net income and statutory net income and between financial statement shareholder's equity and statutory capital and surplus are principally due to the following: policy acquisition costs which are deferred under GAAP but expensed for statutory purposes, certain deferred income taxes which are recorded under GAAP but not for statutory purposes, the timing of the recognition of certain items such as policyholder dividends and pension expenses, and the treatment of certain assets that are charged against statutory capital and surplus under statutory accounting (non-admitted assets).

Under statutory accounting, the Company's capital and surplus was \$577,272,594 as of December 31, 2008, and \$656,849,330 as of December 31, 2007. Statutory net (loss) income for the years ended December 31, 2008 and 2007, was \$(35,870,634) and \$91,855,080, respectively. The statutory net income for the year ended December 31, 2007, includes the statutory earnings of CompWest for all of 2007, whereas consolidated GAAP net income includes the earnings of CompWest only for the period following acquisition.

The Company and all its insurance subsidiaries are subject to state regulations that establish minimum statutory capital and surplus thresholds and place restrictions on annual dividend and other distributions.

The Company and its insurance subsidiaries are also subject to certain Risk-Based-Capital (RBC) requirements as specified by the National Association of Insurance Commissioners (NAIC). RBC determines minimum capital and surplus requirements through an analysis of various risk factors related to each company's operations. As of December 31, 2008 and 2007, the Company and all its insurance subsidiaries had sufficient capital and surplus to exceed all minimum requirements.

State regulatory restrictions limit the maximum amount of annual dividends or other distributions, including loans or cash advances an insurance company may pay its shareholders without prior approval. As of December 31, 2008, the maximum amount of dividends the Company may pay during 2009 without prior approval is \$57,727,000. Accordingly, the remaining amount of its capital and surplus is considered restricted.

## 22. OTHER COMPREHENSIVE LOSS

Other comprehensive loss for the years ended December 31, 2008 and 2007, consists of the following (in thousands):

	<b>2008</b>	<b>2007</b>
Unrealized holding (losses) gains arising during the year	\$ (39,530)	\$ 38,348
Reclassification adjustment for investment losses (gains) included in net income	<u>6,446</u>	<u>(40,974)</u>
Net unrealized losses on investments	(33,084)	(2,626)
Additional pension minimum liability	(7,763)	419
Income tax benefit related to items of other comprehensive income	<u>14,296</u>	<u>919</u>
Other comprehensive loss — net of tax	<u>\$ (26,551)</u>	<u>\$ (1,288)</u>

## 23. CATASTROPHE EXPOSURE

We are exposed to risk of catastrophe as a result of writing of business within certain geographic areas and as a result of writing only one line of business.

Specifically, we insure a small number of employers whose size and concentration of employees in several urban areas expose us to severe financial consequences should a catastrophic event occur at a work location of these employers. We are also exposed on a broad basis to earthquake losses, principally in California. We believe we have mitigated these risks through the purchase of reinsurance.

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