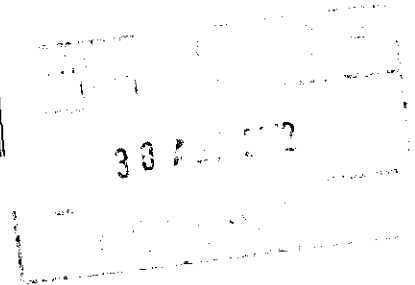




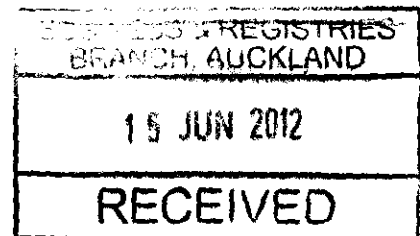
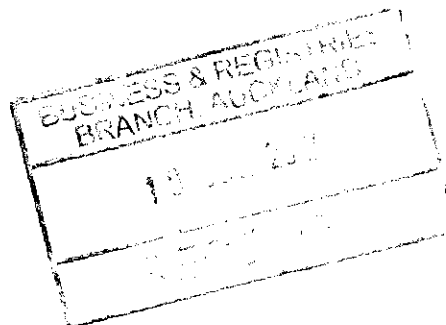
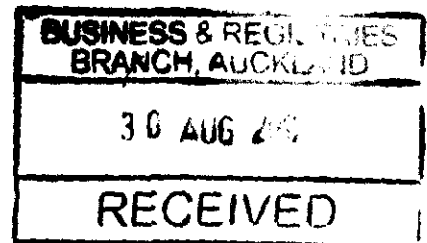
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**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**ANNUAL FINANCIAL REPORT**

**FOR THE YEAR ENDED  
31 DECEMBER 2011**



## DIRECTORS' REPORT

The Directors present their annual report together with the audited Financial Statements for the year ended 31 December 2011.

No disclosure has been made pursuant to Section 211(1) (a) and (e) to (j) of the Companies Act 1993 following a unanimous decision by the shareholders in accordance with Section 211 (3) of the Act.

### RESULT

The loss for the year after tax was \$25,646 (2010 profit: \$100,964)

### DIVIDEND

The Directors recommend that no dividend be paid.

### AUDITORS

In terms of the Companies Act 1993, Ernst & Young are to continue in office as the Branch's auditors.

### APPROPRIATIONS

	\$
Deficit after tax for the year	(25,646)
Less: Net Repatriations	-
Unrealised (Loss) on Investments	(3,770)
Accumulated surplus brought forward	<u>1,717,973</u>
	<u>1,688,557</u>

### ACTIVITIES

The principal activities during the year were those of insurance underwriting and investment.

### DIRECTORS INTERESTS IN TRANSACTIONS

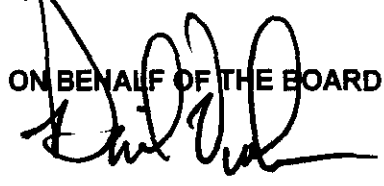
Directors have no interests to declare in the transactions of the year ended 31 December 2011.

### SUBSEQUENT EVENTS

On 20th February 2012, the New Zealand branch of Virginia Surety Company Inc was granted a provisional license to operate as an Insurer under the Insurance (Prudential Supervision) Act 2010 by the Reserve Bank of New Zealand. The New Zealand branch of Virginia Surety Company Inc is currently applying for a full license, the process of which must be fully completed by 7th September 2013.

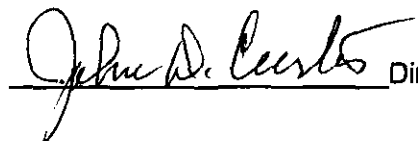
There were no other events since 31st December 2011 which has significantly affected, or may significantly affect, the operations of the branch in future financial years, the results of those operations, or the state of affairs of the company in future financial years.

ON BEHALF OF THE BOARD



Director

15<sup>th</sup> March 2012



Director

15<sup>th</sup> March 2012

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**STATEMENT OF COMPREHENSIVE INCOME**

**FOR THE YEAR ENDED 31 DECEMBER 2011**

	Notes	2011 \$	2010 \$
<b>REVENUE</b>			
Premium revenue		2,951,058	3,551,605
Decrease/(increase) in unearned premium reserve		56,851	(1,469,118)
Investment Income	7	132,634	104,220
<b>TOTAL REVENUE</b>		<b>3,140,543</b>	<b>2,186,707</b>
<b>EXPENSES</b>			
Gross claims incurred	4	1,726,106	1,318,035
Acquisition Costs	16	964,559	167,424
Other operating and administrative expenses	6	498,405	557,014
<b>TOTAL EXPENSES</b>		<b>3,189,070</b>	<b>2,042,473</b>
<b>(LOSS)/PROFIT BEFORE INCOME TAX</b>		<b>(48,527)</b>	<b>144,234</b>
Income Tax Expense	8	22,881	(43,270)
<b>(LOSS)/PROFIT AFTER INCOME TAX</b>		<b>(25,646)</b>	<b>100,964</b>

*The attached notes on pages 8 to 20 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.*

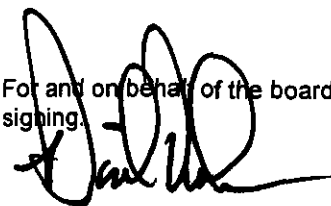
**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**STATEMENT OF FINANCIAL CONDITION**

**AS AT 31 DECEMBER 2011**

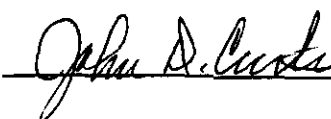
	Notes	2011 \$	2010 \$
<b>ASSETS</b>			
<b>Current assets</b>			
Cash and cash equivalents	9	3,700,135	2,317,387
Trade and other receivables	10	1,652,301	3,261,011
Deferred acquisition costs	16	2,377,996	2,390,289
Deferred Tax assets	8	110,999	75,135
Investments	11	1,500,000	1,500,000
<b>Total current assets</b>		<u>9,341,431</u>	<u>9,543,822</u>
<b>Non-current assets</b>			
Investments	11	546,938	511,042
<b>Total non-current assets</b>		<u>546,938</u>	<u>511,042</u>
<b>TOTAL ASSETS</b>		<u>9,888,369</u>	<u>10,054,864</u>
<b>LIABILITIES</b>			
<b>Current liabilities</b>			
Trade and other payables	12	199,998	285,905
Outstanding claims	15	276,678	248,119
Unearned premiums		7,599,565	7,656,416
Deferred Tax liabilities	8	123,571	146,452
<b>Total current liabilities</b>		<u>8,199,812</u>	<u>8,336,891</u>
<b>TOTAL LIABILITIES</b>		<u>8,199,812</u>	<u>8,336,891</u>
<b>NET ASSETS</b>		<u>1,688,557</u>	<u>1,717,973</u>
<b>DEEMED EQUITY</b>		<u>1,688,557</u>	<u>1,717,973</u>

For and on behalf of the board of directors, who authorised the issue of this financial report on the date of signing.



Director

15<sup>th</sup> March 2012



Director

15<sup>th</sup> March 2012

*The attached notes on pages 8 to 20 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.*

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**  
**STATEMENT OF CHANGES IN HEAD OFFICE ACCOUNT**  
**FOR THE YEAR ENDED 31 DECEMBER 2011**

	<b>2011</b>	<b>2010</b>
	<b>\$</b>	<b>\$</b>
<b>Deemed Equity as at 1 January</b>	<u>1,717,973</u>	<u>1,621,845</u>
<b>(Loss)/Profit for the year</b>	<u>(25,646)</u>	<u>100,964</u>
<b>Total Recognised Revenues and Expenses</b>	<u>1,692,327</u>	<u>1,722,809</u>
<b>Movement in unrealised gain on investments</b>	<u>(3,770)</u>	<u>(4,836)</u>
<b>Deemed Equity as at 31 December</b>	<u>1,688,557</u>	<u>1,717,973</u>

*The attached notes on pages 8 to 20 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.*

## **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

### **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

#### **1. CORPORATE INFORMATION**

These financial statements have been prepared for the New Zealand branch of the Virginia Surety Company Inc., which is incorporated in the United States of America.

##### **Corporate Information**

Virginia Surety Company Inc, incorporated in the United States of America, is the Branch's immediate parent company.

Onex Corporation, incorporated in Canada, is the Branch's ultimate holding company.

#### **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### **Statement of Compliance**

The financial report has been prepared in accordance with NZ GAAP. It complies with the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) and other applicable *Financial Reporting Standards as appropriate for profit oriented entities that qualify for and apply differential reporting concessions*. The branch is a profit oriented entity.

##### **Differential Reporting**

The Branch qualifies for differential reporting exemptions as described in the Framework for Differential Reporting issued by the Institute of Chartered Accountants New Zealand because the Branch is not publicly accountable and there is no separation between the shareholders and the governing body. The Branch has elected to apply all available exemptions except those available under IAS 12 Income Taxes and IAS 18 Revenue which allows revenue and expenses to be recognised inclusive of goods and services tax.

##### **Registered Office**

359 Lincoln Road,  
Christchurch,  
New Zealand, 8024

##### **Insurance Contract**

All of the insurance products offered or utilised by the Branch meet the definition of insurance contracts under the New Zealand equivalents to International Financial Reporting Standards, and *are accounted for and reported in accordance with these standards*.

*These products do not contain embedded derivatives or deposits that are required to be unbundled.*

##### **Basis of Preparation**

The financial statements have been prepared in accordance with generally accepted accounting practice in New Zealand and the requirements of the Companies Act 1993 and the Financial Reporting Act 1993 on a historical cost basis.

The financial statements have been prepared on a going concern basis.

The financial statements are presented in New Zealand dollars.

## **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

### **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

#### **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

##### **Basis of Preparation (continued)**

The following particular accounting policies have been applied:

##### **a) Premium Revenue**

Premium revenue for insurance comprises amounts charged to policyholders. The earned portion of premium received and receivable, including unclosed business, is recognised as revenue. The pattern of recognition of income over the policy or indemnity periods is based on time, which closely approximates the pattern of risks underwritten. Unearned premium is determined by apportioning the premiums written over the period of risk from the date of attachment of risk.

##### **b) Unearned Premium**

Provisions in respect of the proportion of premiums relating to risk in future periods of account are calculated on the straight-line basis over the period of risk.

##### **c) Deferred Acquisition Expenses**

Acquisition expenses, principally comprising commissions and fees incurred on insurance contracts, are deferred and expensed over the period in which the related premiums are earned. Deferred acquisition costs are measured at the lower of cost and recoverable amount.

##### **d) Outstanding Claims**

The Outstanding Claims provision comprises the estimated costs of claims incurred including indirect claims settlement costs, whether reported or not, and claims not settled at balance date. Reported claims have been assessed in the light of the information available at balance date and after taking account of present value of the expected future payments. The provision for claims incurred but not reported has been assessed having regard for the Branch's claim performance. The expected future payments include claims handling costs which are to be incurred in settling the insured claims.

##### **e) Taxation**

Current tax is calculated by reference to the amount of income taxes payable or recoverable in respect of the taxable profit or tax loss for the period. It is calculated using tax rates and tax laws that have been enacted or substantively enacted by reporting date. Current tax for current and prior periods is recognised as a liability (or asset) to the extent that it is unpaid (or refundable).

Deferred tax is accounted for using the comprehensive balance sheet liability method in respect of temporary differences arising from differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax base of those items.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period(s) when the asset and liability giving rise to them are realised or settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by reporting date. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Branch expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Basis of Preparation (continued)**

**e) Taxation (continued)**

Current and deferred tax is recognised as an expense or income in the statement of comprehensive income, except when it relates to items credited or debited directly to equity, in which case the deferred tax is also recognised directly in equity.

**f) Goods and Services Tax**

Revenues, expenses and assets are recognised net of the amount of goods and services tax (GST), except:

- where the amount of GST incurred is not recoverable from the taxation authority, it is recognised as part of the cost of acquisition of an asset or as part of an item of expense; or
- for receivables and payables which are recognised inclusive of GST.

The net amount of GST recoverable from, or payable to, the taxation authority is included as part of receivables or payables.

**g) Investments**

Available-for-sale securities.

Available-for-sale investments are those non-derivative financial assets that are designated as available-for-sale. After initial recognition available-for-sale are measured at fair value with gains or losses recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is recognised in profit or loss. The fair value of investments that are actively traded in organised financial markets are determined by reference to quoted market bid prices at the close of business on the statement of financial condition date. For investments with no active market, fair values are determined using valuation techniques. Such techniques include; using recent arm's length market transactions; reference to the current market value of another instrument that is substantially the same; discounted cash flow analysis and option pricing models making as much use of available and supportable market data and keeping judgemental inputs to a minimum.

**h) Investment Income**

Interest is accounted for on an accrual basis.



**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Basis of Preparation (continued)**

**i) Foreign Currency Translation**

**(i) Functional and presentation currency**

Both the functional and presentation currency of Virginia Surety Company Inc – New Zealand Branch is New Zealand dollars (\$).

**(ii) Transactions & balances**

Transactions in foreign currencies are initially recorded in the functional currency by applying the exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the reporting date.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of the initial transaction. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

**j) Claims**

Reported claims have been assessed in the light of the information available at balance date and after taking account of expected trends in future settlements.

**k) Trade and other receivables**

Trade receivables, which generally have 30 day terms, are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less an allowance for impairment.

Collectability of trade receivables is reviewed on an ongoing basis at an operating unit level. Individual debts that are known to be uncollectible are written off when identified. An impairment provision is recognised when there is objective evidence that the Group will not be able to collect the receivable. Financial difficulties of the debtor, default payments or debts more than 30 days overdue are considered objective evidence of impairment. The amount of the impairment loss is the receivable carrying amount compared to the present value of estimated future cash flows.

**l) Trade and other payables**

Trade and other payables are recognised when the Branch becomes obliged to make future payments resulting from the purchase of goods and services. Payables are recognised at fair value net of transaction costs.

**m) Cash and cash equivalents**

Cash and cash equivalents in the statement of financial position comprise cash at bank and in hand and short term deposits with an original maturity of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

## **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

### **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

#### **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

##### ***Basis of Preparation (continued)***

##### **n) Impairment of assets**

At each reporting date, the Branch reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the Branch estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but only to the extent that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the reversal of the impairment loss is treated as a revaluation increase.

##### **Significant Accounting Judgements, Estimates & Assumption**

The preparation of the financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts in the financial statements. Management continually evaluates its judgements and estimates in relation to assets, liabilities, contingent liabilities, revenue and expenses. Management bases its judgements and estimates on historical experience and on other various factors it believes to be reasonable under the circumstances, the result of which form the basis of the carrying values of assets and liabilities that are not readily apparent from other sources.

##### **New Accounting Standards and Interpretations**

##### ***(i) Changes in accounting policy and disclosures***

The accounting policies adopted are consistent with those of the previous financial year except as follows:

The branch has adopted the following new and amended New Zealand Equivalents to International Financial Reporting Standards and interpretations as of 1 January 2011.

# VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

#### New Accounting Standards and Interpretations (continued)

- *Amendments to NZ IFRS (NZ IAS 32) – Classification of Rights Issues* effective 1 January 2011
- *Amendments to NZ IFRS 1 - Limited Exemption from Comparative NZ IFRS 7 Disclosures for First-time Adopters* effective 1 January 2011
- *Amendments to NZ IFRS 1 - First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards* effective 1 January 2011
- *NZ IFRIC19 - Interpretation 19 Extinguishing Financial Liabilities with Equity Instruments* effective 1 January 2011
- *Amendments to NZ IFRSs arising from the Annual Improvements Project (2010) [NZ IFRS 1, 3, 7, NZ IAS 1, 27, 34, NZ IFRIC 13]* effective 1 January 2011
- *Amendments to NZ IFRIC 14 Prepayments of a Minimum Funding Requirement* effective 1 January 2011
- *Amendments to NZ IAS 24 Related Party Disclosures (Revised 2009)* effective 1 January 2011
- *NZ IAS 24 Related Party Disclosures* (as revised in 2009) amended NZ IFRS 8 effective 1 January 2011

The adoption of the standards and interpretations detailed above are not deemed to have an impact on the financial statements or performance of the branch. The branch has not elected to early adopt any new standards or interpretations that are issued but not yet effective.

### 3. RELATED PARTY TRANSACTIONS

The following table provides the total amount of transactions that were entered into with related parties for the relevant financial year (for information regarding outstanding balances on related party trade receivables and payables at year-end, refer to notes 10 and 12 respectively):

		Sales to Related Parties	Purchases from Related Parties	Expenses Charged by Related Parties
<i>Fellow subsidiaries :</i>		\$	\$	\$
The Warranty Group				
Australasia Pty Ltd	2011	-	-	(409,998)
- expenses paid for on behalf of fellow subsidiary	2010	-	-	(438,138)
The Warranty Group				
Australasia Pty Ltd	2011	-	-	(516,796)
- marketing & administration fees	2010	-	-	(603,318)

During the year, The Warranty Group Australasia Pty Ltd, paid expenses of \$409,998 (2010: \$438,138) on behalf of the New Zealand Branch of Virginia Surety Company Inc. These expenses were recharged to the branch at year end.

During the year, the Australia branch of Virginia Surety Company Inc paid claims of \$75,535 (2010: \$60,481) on behalf of the New Zealand branch. These claim paid were recharged to the New Zealand branch.

Unless otherwise stated, related parties are fellow subsidiaries of the ultimate parent company.

# **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

## **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

### **3. RELATED PARTY TRANSACTIONS (continued)**

#### *Terms and conditions of transactions with related parties*

Sales to and purchases from related parties are made in arm's length transactions both at normal market prices and on normal commercial terms.

Outstanding balances at year-end are unsecured, interest free and settlement occurs in cash.

### **4. CLAIMS INCURRED**

Current year claims relate to risks borne in the current financial year. Prior year claims relate to a reassessment of the risks borne in all previous financial periods.

	2011 \$	2010 \$
Current Year	1,577,135	1,154,252
Prior Years	148,971	163,783
Total Incurred Claims	<u>1,726,106</u>	<u>1,318,035</u>

### **5. AUDITORS' REMUNERATION**

The auditor of the New Zealand branch of Virginia Surety Company Limited is Ernst & Young.

Auditors' fees payable for the audit of the financial report of the company as at 31st December 2011 amounted to \$24,000 (2010: \$15,000).

Auditors' fees charged for the year comprises:

	2011 \$	2010 \$
<b>Auditor Remuneration:</b>		
Audit Fee	25,255	30,000
Tax Compliance	30,805	6,484
	<u>56,060</u>	<u>36,484</u>

### **6. OTHER OPERATING AND ADMINISTRATION EXPENSES**

Other Operating and administration expenses comprises:

	2011 \$	2010 \$
Salaries & Benefits	244,280	252,209
Office & Communication	76,156	86,731
Travel & Entertainment	104,832	127,479
Bank Charges	1,015	652
Bad Debts	993	42,470
Legal Fees	7,375	10,576
Auditors & Consultants Fees	56,060	36,484
Other Expenses	7,694	413
	<u>498,405</u>	<u>557,014</u>

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**7. INVESTMENT INCOME**

	2011 \$	2010 \$
<i>Investment Income comprises:</i>		
Interest on Government Stock	29,894	15,672
Other Interest	102,740	88,548
	<u>132,634</u>	<u>104,220</u>

**8. CURRENT YEAR'S TAXATION**

	2011 \$	2010 \$
<u>Taxation Expense comprises:</u>		
(Loss) / Profit before Taxation	(48,528)	144,234
Current tax expense @ 28%	<u>(13,588)</u>	<u>43,270</u>
Adjustments recognised in the current period in relation to the current tax of prior periods	(9,293)	-
Total Tax Expense	<u>(22,881)</u>	<u>43,270</u>

Current Tax Assets and liabilities

Tax Receivable	110,999	75,135
Tax Payable	-	-
Deferred Tax Liability	<u>(123,571)</u>	<u>(146,451)</u>
<b>Current Tax Asset / (Liability)</b>	<u>(12,572)</u>	<u>(71,316)</u>

Deferred Tax balances

Provision for Doubtful Debts	26,629	30,000
Deferred Acquisition Costs	(665,839)	(717,086)
UOMI & Fair Value gain on bonds	-	8,082
Carry Forward tax losses	513,393	525,432
Other	2,246	(2,373)
Tax rate adjustment	-	9,494
<b>Deferred Tax Asset / (Liability)</b>	<u>(123,571)</u>	<u>(146,451)</u>

**9. CASH AND CASH EQUIVALENTS**

	2011 \$	2010 \$
Cash at bank and in hand	3,700,135	2,317,387

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**10. TRADE AND OTHER RECEIVABLES**

	2011 \$	2010 \$
Investment Income Receivable	14,418	3,895
Premium Debtors	431,847	867,057
Provision for Doubtful Debts	(95,102)	(100,000)
Prepayments	16,058	-
Related Party Receivable	1,285,080	2,490,059
	<u>1,652,301</u>	<u>3,261,011</u>

Related party receivable:

All intercompany balances are with The Warranty Group Australasia Pty Ltd and are due and payable on demand. No interest rates apply to the outstanding amounts.

**11. INVESTMENTS**

	2011 \$	2010 \$
<u>Current</u>		
Short Term Deposit	<u>1,500,000</u>	<u>1,500,000</u>
<u>Non Current</u>		
Government Stock	<u>546,938</u>	<u>511,042</u>
Total Investments	<u>2,046,938</u>	<u>2,011,042</u>

**12. TRADE AND OTHER PAYABLES**

	2011 \$	2010 \$
Trade Payables and Accruals	198,004	285,905
Other Payables	1,994	-
Total Liabilities at amortised cost	<u>199,998</u>	<u>285,905</u>

**13. FINANCIAL INSTRUMENTS**

**a. Categories of Financial Instruments**

	2011 \$	2010 \$
Cash and cash equivalents	3,700,135	2,317,387
Investments	2,046,938	2,011,042
Loans and receivables	1,636,243	3,261,011
Liabilities at amortised cost	201,313	285,905

Financial assets carried at fair value through profit or loss have been designated as such upon initial recognition.

# **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

## **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

### **13. FINANCIAL INSTRUMENTS (continued)**

#### **b. Foreign Exchange**

The Branch does not undertake any transactions denominated in foreign currencies and so exposures in foreign currency do not arise. The foreign currency exposure at the year end was nil.

#### **c. Credit Risk**

Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the branch.

The Branch does not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics. The maximum exposure to credit risk is the amounts shown in the statement of financial condition and notes. The maximum credit risk to the Branch is the carrying value of the assets. The Branch does not have any concentration of credit exposure.

#### **d. Liquidity Risk**

Ultimate responsibility for liquidity risk management rests with the board of directors, who has built an appropriate liquidity risk management framework for the management of the Branch's short, medium and long term funding and liquidity management requirements. The Branch manages liquidity risk by maintaining adequate reserves and banking facilities by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities.

#### **e. Interest Rate Risk**

The Branch is exposed to interest rate risk in that future interest rates movements will affect cash flows:

	<u>Weighted Average</u>	<u>Total</u>	<u>Within 1 Year</u>	<u>Between 1-2 Years</u>	<u>Between 2-3 Years</u>	<u>Between 3-4 Years</u>	<u>Between 4-5+ Years</u>
<b>2011</b>	%	\$	\$	\$	\$	\$	\$
Short Term Deposits	2.25%	1,000,000	1,000,000	-	-	-	-
Bank Bills	2.25%	500,000	500,000	-	-	-	-
Government Securities	6.00%	546,938	-	-	-	546,938	-
	<u>Weighted Average</u> %	<u>Total</u> \$'000	<u>Within 1 Year</u> \$'000	<u>Between 1-2 Years</u> \$'000	<u>Between 2-3 Years</u> \$'000	<u>Between 3-4 Years</u> \$'000	<u>Between 4-5+ Years</u> \$'000
<b>2010</b>							
Short Term Deposits	3.4%	1,000,000	1,000,000	-	-	-	-
Bank Bills	6.0%	500,000	500,000	-	-	-	-
Government Securities	6.0%	511,042	511,042	-	-	-	-

**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH****NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011****13. FINANCIAL INSTRUMENTS (continued)****f. Fair Value of Financial Instruments**

The carrying value of all financial assets and liabilities approximate to their fair value.

**14. CAPITAL COMMITMENTS**

As at 31 December 2011, there were no capital commitments (2010: \$Nil).

**15. CLAIMS PROVISIONS**

	2011 \$	2010 \$
Central Estimate of Expected Future Payments for Claims Reported including:		
Indirect Claims Settlement Costs	276,678	248,119
Gross Provision	<u>276,678</u>	<u>248,119</u>

The percentage risk margin adopted in determining the outstanding claims liability is nil.

Claims provisions are expected to be settled within one year. The amount of expected future payments does not differ materially from the present value; therefore the claims provision has not been discounted.

CLAIMS RESERVE	2011 \$	2010 \$
At Beginning of Year	(248,119)	(260,119)
Claims Incurred	(1,726,106)	(1,318,035)
Claims Settled	1,697,547	1,330,035
At End of Year	<u>(276,678)</u>	<u>(248,119)</u>

**16. DEFERRED ACQUISITION COSTS**

	2011 \$	2010 \$
At Beginning of Year	2,390,289	1,484,704
Costs Incurred	952,266	1,073,010
Recognised in Statement of comprehensive income	(964,559)	(167,424)
At End of Year	<u>2,377,996</u>	<u>2,390,289</u>

**17. ASSETS BACKING GENERAL INSURANCE LIABILITIES**

In determining which assets back general insurance liabilities, a comparison between the asset values and the amount needed to meet claims liabilities and solvency requirements was carried out.



**VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

**18. LIABILITY ADEQUACY TEST**

The liability adequacy test carried out on the insurance portfolio in the current year in accordance with NZ IFRS 4 identified a surplus of \$2,409,730 (2010: \$2,433,253).

	2011	2010
<b><u>Insurance Portfolio</u></b>		
Gross Unearned Premium Reserve	7,599,565	7,656,416
Reinsurance	-	-
<b>Net Unearned Premium</b>	<b>7,599,565</b>	<b>7,656,416</b>
Ultimate Net Loss Ratio	60.1%	63%
Risk Claims (0% discount) Central Estimate	(4,567,339)	(4,823,542)
Claims Handling Costs	-	-
Risk Margin	-	-
<b>Expected Future Claims</b>	<b>(4,567,339)</b>	<b>(4,823,542)</b>
<b>Deferred Acquisition Costs</b>		
Commission Expense	(1,287,029)	(1,283,420)
Administration	(1,090,967)	(1,106,869)
<b>Total Deferred Acquisition Costs</b>	<b>(2,377,996)</b>	<b>(2,390,289)</b>
<b>Level of Surplus / (Deficiency)</b>	<b>2,189,343</b>	<b>2,433,253</b>

The liability adequacy test carried out on the insurance portfolio in the current year, as well as the liability adequacy test carried out in the prior year, identified surpluses, therefore there was no write down of any asset balances.

**19. INSURER FINANCIAL STRENGTH RATING**

Virginia Surety Company Inc has a financial strength rating of A- issued by A M Best (2010: A-)

**20. EQUITY RETAINED FOR THE PURPOSES OF FINANCIAL SOUNDNESS**

The branch retains a level of equity and retained reserves which enable it to maintain an adequate solvency margin for ongoing ability to pay clients. These financial statements relate to a branch of an overseas company. Its assets are available to support the liabilities of the company outside of New Zealand.

**21. CONTINGENT LIABILITIES**

As at 31st December 2011, there were no contingent liabilities existing at balance date (2010: \$Nil) not otherwise provided for in these financial statements.

## **VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH**

### **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2011**

#### **22. SUBSEQUENT EVENTS**

On 20th February 2012, the New Zealand branch of Virginia Surety Company Inc was granted a provisional license to operate as an Insurer under the Insurance (Prudential Supervision) Act 2010 by the Reserve Bank of New Zealand. The New Zealand branch of Virginia Surety Company Inc is currently for applying for a full license, the process for which must be fully completed by 7th September 2013.

There were no other events since 31st December 2011 which has significantly affected, or may significantly affect, the operations of the branch in future financial years, the results of those operations, or the state of affairs of the company in future financial years.

#### **23. OPERATING LEASE OBLIGATIONS**

As at 31st December 2011, the Branch had no obligations payable after balance date on non-cancellable operating leases.

#### **24. FINANCE LEASE LIABILITY**

As at 31st December 2011, the Branch had no obligations payable after balance date on finance leases.

**Independent Auditor's Report****To the Shareholders of Virginia Surety Company, Inc.****Report on the Financial Statements**

We have audited the financial statements of the New Zealand branch of Virginia Surety Company, Inc. Limited on pages 5 to 20, which comprise the statement of financial condition of the New Zealand branch of Virginia Surety Company, Inc. Limited as at 31 December 2011, and the statement of comprehensive income, and statement of changes in head office account for the Year then ended, and a summary of significant accounting policies and other explanatory information.

This report is made solely to the company's shareholders, as a body, in accordance with Section 19(3) of the Financial Reporting Act 1993. Our audit has been undertaken so that we might state to the company's shareholders those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the New Zealand branch of the company and the company's shareholders as a body, for our audit work, for this report, or for the opinions we have formed.

**Directors' Responsibility for the Financial Statements**

The directors are responsible for the preparation of the financial statements, in accordance with generally accepted accounting practice in New Zealand, and that give a true and fair view of the matters to which they relate and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (New Zealand). These auditing standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected, depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we have considered the internal control relevant to the New Zealand branch of the company's preparation of the financial statements that give a true and fair view of the matters to which they relate in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the New Zealand branch of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, as well as evaluating the overall presentation of the financial statements.

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

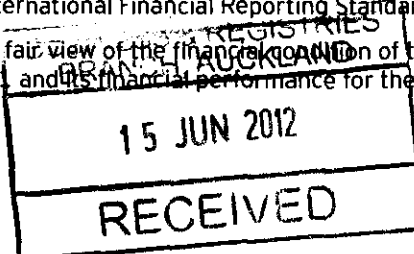
Ernst & Young provides taxation advice to the entity. We have no other relationship, or interest in the entity.

Partners and employees of our firm may deal with the New Zealand branch of the company on normal terms within the ordinary course of trading activities of the business of the New Zealand branch of the company.

**Opinion**

In our opinion, the financial statements on pages 5 to 20:

- ▶ comply with generally accepted accounting practice in New Zealand;
- ▶ comply with International Financial Reporting Standards; and
- ▶ give a true and fair view of the financial condition of the New Zealand branch of the company as at 31 December 2011, and its financial performance for the year then ended.



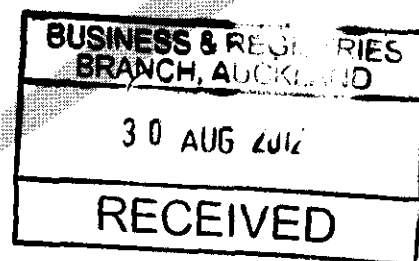
### **Report on Other Legal and Regulatory Requirements**

In accordance with the Financial Reporting Act 1993, we report that:

- ▶ We have obtained all the information and explanations that we have required.
- ▶ In our opinion proper accounting records have been kept by the New Zealand branch of Virginia Surety Company, Inc. Limited as far as appears from our examination of those records.

A handwritten signature in cursive script that reads 'Ernst & Young'.

Ernst & Young  
15 March 2012  
Melbourne



AUDITED STATUTORY-BASIS FINANCIAL  
STATEMENTS AND SUPPLEMENTARY  
INFORMATION

Virginia Surety Company, Inc.  
Years Ended December 31, 2011 and 2010  
With Reports of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

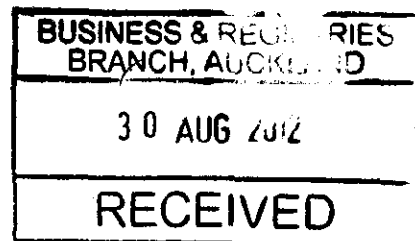
Virginia Surety Company, Inc.

Audited Statutory-Basis Financial Statements  
and Supplementary Information

Years Ended December 31, 2011 and 2010

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## Report of Independent Auditors

The Board of Directors  
Virginia Surety Company, Inc.

We have audited the accompanying statutory-basis balance sheets of Virginia Surety Company, Inc. (the Company) as of December 31, 2011 and 2010, and the related statutory-basis statements of income, changes in capital and surplus, and cash flow for the years then ended. These statutory-basis financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory-basis 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.

As described in Note 2, the accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Insurance, which is a comprehensive basis of accounting other than U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Virginia Surety Company, Inc. at December 31, 2011 and 2010, and the results of its operations and its cash flow for the years then ended, in conformity with accounting practices prescribed or permitted by the Illinois Department of Insurance.

This report is intended solely for the information and use of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

*Ernst & Young LLP*

May 23, 2012

Virginia Surety Company, Inc.

Balance Sheets – Statutory Basis  
(In Thousands, Except Shares and Per Share Data)

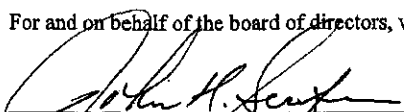
	December 31	
	2011	2010
<b>Admitted assets</b>		
Cash and invested assets:		
Bonds	\$ 770,930	\$ 788,882
Common stocks	3,755	4,276
Short-term investments	20,659	57,806
Cash	81,469	57,090
Receivables for securities	—	126
Total cash and invested assets	876,813	908,180
Agents' balances and uncollected premiums	19,461	16,737
Receivable from parent, subsidiaries, and affiliates	3,877	2,515
Reinsurance balances recoverable	7,945	12,030
Accrued investment income	10,489	10,422
Net deferred tax asset	33,948	38,320
Funds advanced for payment of claims	7,259	6,201
Property, plant, and equipment	400	903
Current federal and foreign income tax recoverable	6,020	10,459
Premium tax receivable	—	204
Other admitted assets	3,928	3,100
 Total admitted assets	 \$ 970,140	 \$ 1,009,071



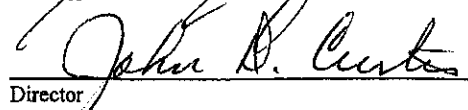
	December 31	
	2011	2010
<b>Liabilities and capital and surplus</b>		
<b>Liabilities:</b>		
Reserves:		
Unearned premium	\$ 514,110	\$ 550,025
Losses and loss adjustment expense	154,503	215,659
Total reserves	668,613	765,684
Funds held and amounts payable to reinsurers	63,246	51,615
Amounts withheld or retained by the Company		
for account of others	7,003	7,797
Ceded reinsurance premiums payable	27,392	31,305
Remittances not allocated	1,849	820
Provision for reinsurance	7,992	7,124
Payable to parent, subsidiaries, and affiliates	2,453	1,268
Other liabilities	22,984	24,702
Loss portfolio transfer	(111,451)	(169,297)
Liability for retroactive reinsurance	(6,234)	(6,003)
Total liabilities	683,847	715,015
<b>Capital and surplus:</b>		
Common stock, par value \$1 per share;		
authorized, issued, and outstanding –		
5,000,000 shares	5,000	5,000
Additional paid-in capital	145,895	145,895
Special surplus fund	15,521	18,951
Unassigned surplus	119,877	124,210
Total capital and surplus	286,293	294,056
Total liabilities and capital and surplus	\$ 970,140	\$ 1,009,071

See accompanying notes.

For and on behalf of the board of directors, who authorized the issue of this financial report on the date of the signing.

  
Director

8/22/2012  
Date

  
Director

8/22/2012  
Date

Virginia Surety Company, Inc.

Statements of Income – Statutory Basis  
(In Thousands)

	Year Ended December 31	
	2011	2010
Premiums earned	\$ 324,888	\$ 349,219
Losses and loss adjustment expenses incurred	151,728	232,731
Commission expenses	45,756	41,980
Other underwriting expenses	39,017	41,078
Loss portfolio transfer – reinsurance ceded	31,047	(9,379)
Underwriting income	57,340	42,809
Net investment income	38,191	39,891
Net realized investment gains	1,817	11,506
Retrospective reinsurance ceded	3,136	5,916
Income before income taxes	100,484	100,122
Income taxes	28,291	25,620
Net income	\$ 72,193	\$ 74,502

See accompanying notes.

Virginia Surety Company, Inc.

Statements of Changes in Capital and Surplus – Statutory Basis  
(In Thousands)

	Common Stock	Additional Paid In- Capital	Special Surplus Fund	Unassigned Surplus	Total Surplus
Balance at January 1, 2010	\$ 5,000	\$ 145,895	\$ 20,219	\$ 131,823	\$ 302,937
Net income	–	–	–	74,502	74,502
Changes in:					
Net unrealized capital loss, net of tax	–	–	–	(2,895)	(2,895)
Provision for reinsurance	–	–	–	704	704
Cumulative translation adjustment account, net of tax	–	–	–	3,251	3,251
Net deferred tax assets	–	–	–	(7,614)	(7,614)
Non-admitted assets	–	–	–	(3,503)	(3,503)
Correction of prior period error (Note 14)	–	–	–	(7,058)	(7,058)
Decrease in deferred tax assets from SSAP No. 10R (Note 5)	–	–	(1,268)	–	(1,268)
Dividend to parent	–	–	–	(65,000)	(65,000)
Balance at December 31, 2010	5,000	145,895	18,951	124,210	294,056
Net income	–	–	–	72,193	72,193
Changes in:					
Net unrealized capital gain, net of tax	–	–	–	2,460	2,460
Provision for reinsurance	–	–	–	(868)	(868)
Cumulative translation adjustment account, net of tax	–	–	–	(1,446)	(1,446)
Net deferred tax assets	–	–	–	(1,841)	(1,841)
Non-admitted assets	–	–	–	(831)	(831)
Decrease in deferred tax assets from SSAP No. 10R (Note 5)	–	–	(3,430)	–	(3,430)
Dividend to parent	–	–	–	(74,000)	(74,000)
Balance at December 31, 2011	\$ 5,000	\$ 145,895	\$ 15,521	\$ 119,877	\$ 286,293

See accompanying notes.

Virginia Surety Company, Inc.

Statements of Cash Flow – Statutory Basis  
(In Thousands)

	Year Ended December 31	
	2011	2010
<b>Operating activities</b>		
Premiums collected, net of reinsurance	\$ 294,628	\$ 297,999
Losses and loss adjustment expenses paid	(169,731)	(191,080)
Underwriting expenses paid	(90,798)	(94,815)
Net investment income received	42,513	46,158
Federal income taxes paid	(23,852)	(33,978)
Net cash provided by operating activities	52,760	24,284
<b>Investing activities</b>		
Sale, maturity, or repayment of investments	210,592	350,147
Purchase of investments	(197,763)	(275,998)
Net cash provided by investing activities	12,829	74,149
<b>Financing and miscellaneous activities</b>		
Dividend to parent	(74,000)	(65,000)
Net transfers to affiliates and other activities	(4,357)	(8,807)
Net cash used in financing activities	(78,357)	(73,807)
Net (decrease) increase in cash and short-term investments	(12,768)	24,626
Cash and short-term investments at beginning of year	114,896	90,270
Cash and short-term investments at end of year	\$ 102,128	\$ 114,896

See accompanying notes.

# Virginia Surety Company, Inc.

## Notes to Financial Statements – Statutory Basis (Dollars in Thousands)

December 31, 2011

### 1. Nature of Operations

Virginia Surety Company, Inc. (the Company) is a property and casualty insurance company domiciled in Illinois. The Company primarily writes mechanical repair and appliance extended warranty coverages, as well as several other lines of business throughout the United States and in certain foreign locations. The Company is currently licensed in all 50 states and the District of Columbia in the United States, Guam, Puerto Rico and Canada. The Company is a wholly owned subsidiary of TWG Holdings, Inc. (TWG). TWG is 100% owned by The Warranty Group, Inc.

### 2. Summary of Significant Accounting Policies

#### Basis of Presentation

The accompanying statutory-basis financial statements of the Company have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Insurance (the Department). Such practices differ from U.S. generally accepted accounting principles (GAAP). The more significant variances from GAAP are as follows:

#### *Investments*

Investments in bonds are reported at amortized cost using the scientific method or fair value. For GAAP, such fixed maturity investments are designated at purchase as either held-to-maturity, trading, or available-for-sale. Available-for-sale investments are stated at fair value, with unrealized holding gains and losses reported in accumulated other comprehensive income (loss), net of deferred federal income taxes. Held-to-maturity securities are stated at amortized cost. Trading securities are stated at fair value, with unrealized holding gains and losses reported in the Company's statutory-basis statements of income as part of net realized gains (losses).

The amortized cost of fixed maturities other than mortgage-backed and asset-backed securities is adjusted for amortization of premiums and the accretion of discounts on a yield-basis method.

Fair value for statutory purposes is based on prices received either from the National Association of Insurance Commissioners (NAIC) Securities Valuation Office (SVO) or an independent third-party vendor. If fair value pricing is unavailable from these sources, the Company uses either broker-dealers or matrix pricing for reporting and disclosing fair values of investment securities.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**2. Summary of Significant Accounting Policies (continued)**

All single-class and multi-class mortgage-backed/asset-backed securities, such as collateralized mortgage obligations (CMOs), are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the retrospective method. If it is determined that a decline in fair value is other-than-temporary because the Company intends to sell the security or has assessed that it does not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amortized cost basis is written down to fair value as a realized loss in the statutory-basis statements of income. If deemed other-than-temporarily impaired as the Company does not expect to recover the amortized cost basis even if it did not intend to sell the security, and the Company has the intent and ability to hold the security, the amortized cost basis is written down to the present value of future cash flows as a realized loss in the statutory-basis statements of income.

For GAAP purposes, all securities, purchased or retained, that represent beneficial interests in securitized assets, such as CMOs, mortgage-backed securities and asset-backed securities, other than high credit quality securities, are adjusted using the prospective method when there is a change in estimated future cash flows. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the fair value. If high credit quality securities are adjusted, the retrospective method is used. For impaired fixed maturity securities that the Company does not intend to sell, or if it is more likely than not that the Company will not have to sell such securities but expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in the statutory-basis statements of income, and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income. Furthermore, unrealized losses entirely caused by non-credit related factors related to fixed maturity securities for which the Company expects to fully recover the amortized cost basis continue to be recognized in other comprehensive income.

Short-term investments consist of readily marketable securities with maturities greater than three months but less than one year at the time of purchase. These investments are recorded at amortized cost or fair value.

*Subsidiaries*

The accounts and operations of the Company's subsidiaries are not consolidated with the accounts and operations of the Company as would be required under GAAP.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**2. Summary of Significant Accounting Policies (continued)**

*Policy Acquisition Costs*

The costs of acquiring and renewing business are charged to expense when incurred. Under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective period of the related insurance policies.

*Non-admitted Assets*

Certain assets designated as non-admitted, principally past-due affiliated receivable balances, past-due agents' balances, uncollected premiums, nonoperating software and property and equipment, affiliated subsidiary investments, and other assets not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual* of the NAIC, are excluded from the accompanying balance sheets by a direct charge to unassigned surplus. These non-admitted assets totaled \$43,316 and \$42,485 at December 31, 2011 and 2010, respectively. Under GAAP, these amounts are carried as an asset, net of a valuation allowance, if necessary.

*Reinsurance*

A liability for reinsurance balances has been provided for unsecured unearned premiums and unpaid losses ceded to reinsurers unauthorized by license to assume such business in Illinois and for certain unsecured overdue reinsurance balances. Changes to those amounts are credited or charged directly to unassigned surplus. Under GAAP, an allowance for amounts deemed uncollectible would be established through a charge to income.

Reserves for losses and loss adjustment expenses and unearned premiums ceded to reinsurers have been reported as reductions of the related reserves rather than as assets, as would be required under GAAP.

Commissions allowed by reinsurers on business ceded are reported as income when incurred, rather than being deferred and amortized with deferred policy acquisition costs as required under GAAP. Any excess commission is deferred and recognized over the policy term consistent with GAAP.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**2. Summary of Significant Accounting Policies (continued)**

For reinsurance contracts that do not transfer insurance risk, the cash transactions between the ceding and assuming companies are reflected in the statutory-basis balance sheets as a deposit. Other income or loss is recognized when cash is transferred subsequent to the depletion of the deposit or through the elimination of any remaining deposit upon the completion of the contract. The amount of the deposit asset (or liability) is adjusted by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments with a corresponding credit or charge to interest income or expense.

*Deferred Income Taxes*

The Company adopted the provisions of Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP No. 10*, in 2009. For the years ended December 31, 2011 and 2010, the Company elected to apply paragraph 10e, allowing for additional deferred income tax assets to be admitted. In order to qualify for the elective standard, the Company must exceed the risk-based capital threshold, based on the Company's risk-based capital amount. As a result, the Company recorded additional admitted deferred tax assets of \$15,521 and \$18,951 at December 31, 2011 and 2010, respectively, which are reported directly in capital and surplus.

Deferred tax assets that are more likely than not expected to be realized are limited to: (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse within three years of the balance sheet date; plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within three years of the balance sheet date, or 15% of capital and surplus, as of December 31, 2011 and 2010, excluding any net deferred tax assets, electronic data processing equipment and operating software, and any net positive goodwill; plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are nonadmitted. Under GAAP, the deferred tax benefits of the deferred tax assets are recognized to the extent realization of such benefits is more likely than not.



Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**2. Summary of Significant Accounting Policies (continued)**

*Statements of Cash Flow*

Cash and short-term investments in the statutory-basis statements of cash flow represent cash balances and investments with initial maturities of one year or less. If in the aggregate the Company has a negative cash balance, it is reported as a negative asset and not as a liability. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with remaining maturities of three months or less when purchased, and negative cash balances are reported as liabilities. The statutory-basis statements of cash flow are presented in a prescribed regulatory format rather than that required by Accounting Standards Codification (ASC) Topic 230, *Statement of Cash Flows*.

The effects of the foregoing variances from GAAP on the accompanying statutory-basis financial statements have not been determined but are presumed to be material.

Other significant accounting practices follow:

**Investments**

Bonds, common stocks, and short-term investments are stated at values prescribed by the NAIC, as follows:

Bonds not backed by other loans are reported at amortized cost using the scientific method or fair value. The cost of bonds are adjusted for amortization of premiums and accretion of discounts using the scientific amortization method. Bonds rated NAIC 3 or lower are stated at the lower of amortized cost or fair value. Fair values for statutory purposes are based on prices received either from the NAIC SVO or an independent third-party vendor. If fair value pricing is unavailable from these sources, the Company uses either broker-dealers or matrix pricing for reporting and disclosing fair values of investment securities. Adjustments to reduce bonds to their fair value are reported as reductions in unassigned surplus along with any adjustment for federal income taxes.

For asset-backed and mortgage-backed securities, the interest method includes anticipated prepayments. Prepayment assumptions are obtained from broker-dealer survey values, actual history and expert forecasts. The retrospective adjustment method is used to value all such securities.

## Virginia Surety Company, Inc.

### Notes to Financial Statements – Statutory Basis (continued) (Dollars in Thousands)

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

Common stocks are reported at fair value as determined by the SVO, and the related unrealized capital gains and losses are reported in unassigned surplus along with any adjustment for federal income taxes.

The Company's wholly owned noninsurance subsidiaries (TWG Home Warranty Services, Inc., Virginia Surety Compania de Seguros, and The Warranty Group Columbia S.A.) have not obtained audits under GAAP and as a result, the value of the Company's investment in the subsidiaries is nonadmitted in accordance with SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, a Replacement of SSAP No. 88*. The Company had non-admitted investments in affiliates totaling \$8,762 and \$6,127 at December 31, 2011 and 2010, respectively.

Short-term investments include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at amortized cost or fair value.

Realized investment gains and losses are determined using the specific-identification basis, and the related unrealized capital gains and losses are reported in unassigned surplus along with any adjustment for federal income taxes.

#### Electronic Data Processing Equipment and Software

Electronic data processing (EDP) equipment and software are recorded at cost less accumulated depreciation. The admitted value of the Company's EDP equipment and operating software is limited to 3% of capital and surplus, excluding any net deferred tax assets, EDP equipment and operating software, and any net positive goodwill. Depreciation on EDP and operating software is computed principally by the straight-line method over the lesser of the useful lives of the assets or three years. Nonoperating software is depreciated using the straight-line method over the lesser of its useful life or five years. The net book value related to nonoperating software is charged in full to unassigned surplus as a nonadmitted asset. Accumulated depreciation at December 31, 2011 and 2010, was \$37,803 and \$32,405, respectively. Depreciation expense in 2011 and 2010 was \$5,398 and \$5,744, respectively.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**2. Summary of Significant Accounting Policies (continued)**

**Furniture and Equipment**

Furniture and equipment is capitalized and depreciated on a straight-line basis over its useful life.

Accumulated depreciation at December 31, 2011 and 2010, was \$3,000 and \$2,537, respectively. Depreciation expense in 2011 and 2010 was \$463 and \$675, respectively.

**Funds Held**

The Company holds funds on behalf of unaffiliated companies in conjunction with certain reinsurance arrangements in order to securitize risks transferred as part of these reinsurance transactions. These balances are recorded as liabilities on the Company's statutory-basis balance sheets.

**Premium Revenue Recognition**

Unearned premium reserves on single-premium insurance related to warranty agreements are calculated to result in premiums being earned over the period at risk. The calculations are based on historical analyses of claim payment patterns over the duration of the policies in force which in some circumstances supports the use of a pro-rata method. All other non-warranty premium revenues are determined on a pro-rata method.

**Losses and Loss Adjustment Expense Reserves**

Losses and loss adjustment expense reserves represent the estimated ultimate net cost of all reported and unreported losses incurred and unpaid through December 31. The Company does not discount losses and loss adjustment expense reserves. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**2. Summary of Significant Accounting Policies (continued)**

**Reinsurance**

Reinsurance premiums, commissions, 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.

**Foreign Currency Translation**

Foreign revenues and expenses are translated at average monthly exchange rates. Foreign assets and liabilities are translated at exchange rates at the balance sheet dates. Net foreign exchange gains and losses are charged or credited directly to unassigned surplus.

**Use of Estimates**

The preparation of statutory-basis financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the statutory-basis financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known that could impact the amounts reported and disclosed herein.

**Reclassifications**

*Certain amounts in the accompanying statutory-basis financial statements and related notes have been classified differently from their presentation in the Company's annual statement filed with regulatory authorities. These reclassifications have no impact on net income or capital and surplus. In addition, certain amounts in the 2010 statutory-basis financial statements and related notes have been reclassified to conform to the 2011 statutory-basis financial statement presentation.*

**New Accounting Pronouncements**

In 2011, the Company adopted substantive revisions to SSAP No. 5, Liabilities, Contingencies, and Impairments of Assets (now referred to as SSAP No. 5(R)). The revisions require a company to recognize a liability at the inception of the guaranty, even if the likelihood of payment is remote. Additional disclosures also are required for guarantees. Adoption of SSAP No. 5(R) did not have a material effect on the statutory-basis financial statements.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**2. Summary of Significant Accounting Policies (continued)**

In November 2011, the NAIC adopted SSAP No. 101, *Income Taxes*, which supersedes the guidance in SSAP No. 10 and SSAP No. 10(R). The guidance adds conservatism in the accounting for tax contingencies by applying a modified SSAP No. 5(R) approach and includes revisions to the admissibility calculation for DTAs. SSAP No. 101 and the related changes to SSAP No. 5(R) are effective for periods beginning January 1, 2012. The Company does not expect adoption in 2012 to have a material effect on the statutory-basis financial statements.

**Subsequent Events**

Management of the Company has evaluated all events occurring after December 31, 2011 through May 23, 2012, the date the statutory-basis financial statements were available to be issued, to determine whether any event required either recognition or disclosure in the statutory-basis financial statements. No material subsequent events were noted.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**3. Investments**

The statement value, gross unrealized gains and losses, and fair value of investments in bonds are summarized as follows:

	<b>Statement Value</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>December 31, 2011</b>				
U.S. government and agencies	\$ 9,196	\$ 733	\$ —	\$ 9,929
States and political subdivisions	118,471	10,411	—	128,882
Foreign governments	94,591	2,598	(61)	97,128
Corporate bonds	227,032	25,005	(28)	252,009
Commercial mortgage-backed	65,689	2,453	(82)	68,060
Residential mortgage-backed	206,119	10,458	(150)	216,427
Asset-backed securities	49,832	499	(522)	49,809
Total bonds	<u>\$ 770,930</u>	<u>\$ 52,157</u>	<u>\$ (843)</u>	<u>\$ 822,244</u>
<b>December 31, 2010</b>				
U.S. government and agencies	\$ 28,289	\$ 544	\$ (111)	\$ 28,722
States and political subdivisions	60,182	536	(1,133)	59,585
Foreign governments	114,326	1,743	(515)	115,554
Corporate bonds	296,642	23,886	(70)	320,458
Commercial mortgage-backed	38,821	1,823	—	40,644
Residential mortgage-backed	209,346	7,090	(506)	215,930
Asset-backed securities	41,276	1,706	(2)	42,980
Total bonds	<u>\$ 788,882</u>	<u>\$ 37,328</u>	<u>\$ (2,337)</u>	<u>\$ 823,873</u>

There are no significant industries or other concentrations of investments in bonds as of December 31, 2011 or 2010.

The Company recorded adjustments to reduce certain bonds rated NAIC 3 or higher to their fair value when the fair value was lower than amortized cost. As of December 31, 2011 and 2010, these adjustments reduced the statement value of bonds by \$31 and \$4, respectively, with a corresponding reduction in unassigned surplus, net of taxes.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**3. Investments (continued)**

The statement value and fair value of bonds at December 31, 2011, by contractual maturity, are shown below. Expected maturities differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<b>Statement Value</b>	<b>Fair Value</b>
Years to maturities:		
One or less	\$ 79,167	\$ 79,903
After one through five	166,872	178,076
After five through ten	139,122	160,419
After ten	64,129	69,550
Commercial mortgage-backed	65,689	68,060
Residential mortgage-backed	206,119	216,427
Asset-backed securities	49,832	49,809
	<u>\$ 770,930</u>	<u>\$ 822,244</u>

Proceeds from the sale of investments in bonds were \$41,393 and \$220,727 in 2011 and 2010, respectively. Gross gains of \$1,773 and gross losses of \$4 were realized on those sales in 2011. Gross gains of \$8,890 and gross losses of \$40 were realized on those sales in 2010.

At December 31, 2011, bonds with an admitted asset value of \$29,146 were on deposit with various state insurance departments and Canadian insurance regulators to satisfy regulatory requirements.

At December 31, 2011 and 2010, bonds with a carrying value of \$87,708 and \$105,701, respectively, were denominated in currencies other than the U.S. dollar.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**3. Investments (continued)**

The cost, gross unrealized gains and losses, and fair value of investments in common stocks (unaffiliated and affiliated) are summarized as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2011</b>				
Common stocks – unaffiliated	\$ 3,707	\$ 78	\$ (30)	\$ 3,755
Common stocks – affiliated	9,974	2,506	(3,718)	8,762
Total	<u>\$ 13,681</u>	<u>\$ 2,584</u>	<u>\$ (3,748)</u>	<u>\$ 12,517</u>
<b>December 31, 2010</b>				
Common stocks – unaffiliated	\$ 3,915	\$ 362	\$ (1)	\$ 4,276
Common stocks – affiliated	9,974	–	(3,847)	6,127
Total	<u>\$ 13,889</u>	<u>\$ 362</u>	<u>\$ (3,848)</u>	<u>\$ 10,403</u>

The Company nonadmitted the fair value of affiliated common stocks of \$8,762 and \$6,127 at December 31, 2011 and 2010, respectively.

The following is a summary of the sources of net investment income for the year ended December 31:

	2011	2010
Bonds	\$ 34,178	\$ 36,710
Common stocks (unaffiliated)	99	131
Cash, cash equivalents, and short-term investments	5,076	3,714
Investment, interest, and other expenses	(1,162)	(664)
Total	<u>\$ 38,191</u>	<u>\$ 39,891</u>



Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**3. Investments (continued)**

The components of net realized investment gains (losses) are as follows:

	<b>Year Ended December 31</b>	
	<b>2011</b>	<b>2010</b>
Bonds:		
Gross gains	\$ 1,773	\$ 8,961
Gross losses	(4)	(350)
Other-than-temporary impairments	–	(2,432)
	<u>1,769</u>	<u>6,179</u>
Common stocks:		
Gross gains	140	5,863
Gross losses	–	(584)
	<u>140</u>	<u>5,279</u>
Other	(92)	48
Net realized investment gains	<u>\$ 1,817</u>	<u>\$ 11,506</u>

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for impairing securities that sustain other-than-temporary declines in value. The decision to impair a security incorporates both quantitative criteria and qualitative information. The impairment review process considers a number of factors, including but not limited to: (a) the length of time and the extent to which a security's fair value has been less than statement value, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time to allow for any anticipated recovery in value, (d) whether the debtor is current on interest and principal payments, and (e) general market conditions and industry- or sector-specific factors. For securities deemed to be other-than-temporarily impaired, the security is adjusted to its fair value, and the resulting losses are recognized in net realized gains or losses in the statutory-basis statements of income. The Company recorded other-than-temporary impairment losses on securities of \$0 and \$2,432 during 2011 and 2010, respectively.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

3. Investments (continued)

The following table analyzes the Company's unaffiliated investment positions with unrealized losses segmented by type and period of continuous unrealized loss:

	Less Than 12 Months		Greater Than 12 Months		Total		
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Number of Securities
<b>December 31, 2011</b>							
Bonds:							
U.S. government and agencies	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-
States and political subdivisions	-	-	20	-	20	-	1
Foreign governments	-	-	8,676	61	8,676	61	3
Corporate bonds	2,979	22	2,046	6	5,025	28	3
Commercial mortgage-backed	14,030	82	-	-	14,030	82	4
Residential mortgage-backed	9,055	150	-	-	9,055	150	4
Asset-backed securities	26,678	279	1,416	243	28,094	522	11
Total bonds	52,742	533	12,158	310	64,900	843	26
Equity securities:							
Common stock – unaffiliated	2,566	28	16	2	2,582	30	3
	\$ 55,308	\$ 561	\$ 12,174	\$ 312	\$ 67,482	\$ 873	\$ 29
<b>December 31, 2010</b>							
Bonds:							
U.S. government and agencies	\$ 4,043	\$ 111	\$ -	\$ -	\$ 4,043	\$ 111	\$ 6
States and political subdivisions	41,842	1,132	19	1	41,861	1,133	39
Foreign governments	27,341	320	18,589	195	45,930	515	21
Corporate bonds	1,610	13	11,698	57	13,308	70	11
Commercial mortgage-backed	-	-	-	-	-	-	-
Residential mortgage-backed	27,059	506	-	-	27,059	506	6
Asset-backed securities	1,913	2	-	-	1,913	2	1
Total bonds	103,808	2,084	30,306	253	134,114	2,337	84
Equity securities:							
Common stock – unaffiliated	64	1	-	-	64	1	2
	\$ 103,872	\$ 2,085	\$ 30,306	\$ 253	\$ 134,178	\$ 2,338	\$ 86

## Virginia Surety Company, Inc.

### Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

#### **3. Investments (continued)**

The Company's bond portfolio is sensitive to interest rate fluctuations, which impact the fair value of individual securities. All unrealized losses reported above related to the Company's investment in bonds were caused by the effect of a rising interest rate environment on certain securities with stated interest rates currently below market rates. The Company has the ability and intent to hold these securities until their full cost can be recovered. Unrealized losses on equity securities result from normal market fluctuations and are considered temporary. Therefore, the Company does not believe these unrealized losses on bonds or equity securities represent an other-than-temporary impairment as of December 31, 2011.

#### **4. Fair Value of Financial Instruments**

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in the fair value statutory accounting guidance as defined in SSAP No. 100, *Fair Value Measurements*. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable market inputs (Level 3). The three levels of the hierarchy are as follows:

- Level 1 includes financial instruments whose fair value is determined based on observable unadjusted quoted market prices for identical financial assets or liabilities in active markets that the Company has the ability to access at the measurement date. This is the most reliable fair value measurement and includes, for example, active exchange-traded securities.
- Level 2 includes financial instruments whose fair value is determined based upon various inputs including, but not limited to, quoted market prices for similar assets in active markets, quoted market prices for identical assets in inactive markets, inputs other than quoted market prices that are observable for the asset such as interest rates or yield curves, or other inputs derived principally from other observable market information. When quoted market prices in active markets are not available, fair values are derived through matrix pricing, which is a mathematical technique, used principally to value debt securities by relying on the securities' relationship to other benchmark-quoted securities and not by relying exclusively on quoted market prices for specific securities.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**4. Fair Value of Financial Instruments (continued)**

- Level 3 includes financial instruments whose fair value is determined from techniques in which one or more of the significant inputs, such as assumptions about risk, are unobservable. Because Level 3 fair values contain unobservable market inputs, judgment must be used to determine fair values. Level 3 fair values represent the best estimate of an amount that could be realized in a current market exchange absent actual market exchanges.

The following methods and assumptions were used by the Company in estimating the fair value of financial instruments in the accompanying statutory-basis financial statements and notes thereto:

*Cash, Short-Term Investments, and Receivables:* The carrying amounts reported in the accompanying statutory-basis balance sheets for these financial instruments approximate their fair values.

*Investment Securities:* Fair values for statutory purposes are based on prices received either from the NAIC SVO or an independent third-party vendor. If fair value pricing is unavailable from these sources, the Company uses either broker-dealers or matrix pricing for reporting and disclosing fair values of investment securities.

For fixed maturity securities not actively traded, fair values are estimated using values obtained from independent pricing services or, in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the coupon rate, credit, and maturity of the investments.

*Liabilities for Insurance Contracts:* The fair values of the Company's liabilities for insurance contracts other than investment-type contracts are not required to be disclosed. However, the fair values of liabilities under all insurance contracts are taken into consideration in the Company's overall management of interest rate risk such that the Company's exposure to changing interest rates is minimized through the matching of investment maturities with amounts due under insurance contracts.

Additional data with respect to fair values of the Company's investments is disclosed in Note 3.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**4. Fair Value of Financial Instruments (continued)**

The table below summarizes the Company's investments reported at fair value in the accompanying statutory-basis financial statements at December 31, 2011 and 2010.

	Total	Level 1	Level 2	Level 3
<b>December 31, 2011</b>				
Fixed maturity securities	\$ 5,449	\$ –	\$ 5,449	\$ –
Total fixed-maturity securities	<u>\$ 5,449</u>	<u>\$ –</u>	<u>\$ 5,449</u>	<u>\$ –</u>
Equity securities:				
Money market mutual fund	\$ 3,755	\$ 3,755	\$ –	\$ –
Total equity securities	<u>\$ 3,755</u>	<u>\$ 3,755</u>	<u>\$ –</u>	<u>\$ –</u>
<b>December 31, 2010</b>				
Fixed maturity securities	\$ 4,250	\$ –	\$ 4,250	\$ –
Total fixed-maturity securities	<u>\$ 4,250</u>	<u>\$ –</u>	<u>\$ 4,250</u>	<u>\$ –</u>
Equity securities:				
Industrial and miscellaneous	\$ 568	\$ 568	\$ –	\$ –
Money market mutual fund	3,708	3,708	–	–
Total equity securities	<u>\$ 4,276</u>	<u>\$ 4,276</u>	<u>\$ –</u>	<u>\$ –</u>

The Company did not have any financial instruments recorded at fair value based on the criteria outlined in Level 3.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**5. Federal Income Taxes**

The components of the Company's net deferred tax asset (DTA) and net deferred liability (DTL) at December 31 as calculated under SSAP 10R Paragraph 10 are as followed:

	2011		
	Ordinary	Capital	Total
Total gross and adjusted DTA	\$ 48,654	\$ 5	\$ 48,659
Total of all DTL	(13,884)	(827)	(14,711)
Net DTA (DTL)	34,770	(822)	33,948
Less DTA non-admitted	-	-	-
Net admitted DTA (DTL)	\$ 34,770	\$ (822)	\$ 33,948
	2010		
	Ordinary	Capital	Total
Total gross and adjusted DTA	\$ 51,725	\$ 70	\$ 51,795
Total of all DTL	(13,283)	(76)	(13,359)
Net DTA (DTL)	38,442	(6)	38,436
Less DTA non-admitted	(46)	(70)	(116)
Net admitted DTA (DTL)	\$ 38,396	\$ (76)	\$ 38,320
	Change		
	Ordinary	Capital	Total
Total gross and adjusted DTA	\$ (3,071)	\$ (65)	\$ (3,136)
Total of all DTL	(601)	(751)	(1,352)
Net DTA (DTL)	(3,672)	(816)	(4,488)
Less DTA non-admitted	46	70	116
Net admitted DTA (DTL)	\$ (3,626)	\$ (746)	\$ (4,372)

The Company has elected to admit additional DTAs pursuant to SSAP 10R, paragraph 10e.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

The increased amount, by tax character, of admitted adjusted gross DTAs resulting from paragraph 10e:

	2011	2010	Change
Ordinary	\$ 15,516	\$ 18,951	\$ (3,435)
Capital	5	—	5
Total	<u>\$ 15,521</u>	<u>\$ 18,951</u>	<u>\$ (3,430)</u>

The amount of each result or component of the calculation, by tax character, of paragraph 10a, 10bi, 10bii, and 10c at December 31:

	2011		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10a)	\$ 18,427	\$ —	\$ 18,427
Lesser of:			
Expected to be recognized within one year (10bi) or	—	—	—
10% of adjusted capital and surplus (10bii)	30,515		30,515
Adjusted gross DTAs offset against existing DTLs (10c)	14,711	—	14,711
Risk-based capital level used in paragraph 10d:			
Total adjusted capital	—	—	270,772
Authorized control level	—	—	44,858

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

5. Federal Income Taxes (continued)

	2010		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10a)	\$ 19,369	\$ –	\$ 19,369
Lesser of:			
Expected to be recognized within one year (10bi) or	–	–	–
10% of adjusted capital and surplus (10bii)	30,741		30,741
Adjusted gross DTAs offset against existing DTLs (10c)	13,359	–	13,359
Risk-based capital level used in paragraph 10d:			
Total adjusted capital	–	–	275,105
Authorized control level	–	–	45,394
	Change		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10a)	\$ (942)	\$ –	\$ (942)
Lesser of:			
Expected to be recognized within one year (10bi) or	–	–	–
10% of adjusted capital and surplus (10bii)	(226)		(226)
Adjusted gross DTAs offset against existing DTLs (10c)	1,352	–	1,352
Risk-based capital level used in paragraph 10d:			
Total adjusted capital	–	–	(4,333)
Authorized control level	–	–	(536)



Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

The amount of each result or component of the calculation, by tax character, of paragraphs 10ei, 10eii(a), 10eii(b), and 10eiii at December 31:

	2011		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10ei)	\$ 29,618	\$ –	\$ 29,618
Lesser of:			
Expected to be recognized within three years (10eii(a)) or	7,225	–	7,225
15% of adjusted capital and surplus (10eiii(b))	45,773	–	45,773
Adjusted gross DTAs offset against existing DTLs (10eiii)	11,811	5	11,816
	2010		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10ei)	\$ 30,962	\$ –	\$ 30,962
Lesser of:			
Expected to be recognized within three years (10eii(a)) or	7,358	–	7,358
15% of adjusted capital and surplus (10eiii(b))	46,112	–	46,112
Adjusted gross DTAs offset against existing DTLs (10eiii)	13,359	5	13,364
	Change		
	Ordinary	Capital	Total
Recovered through loss carrybacks (10ei)	\$ (1,344)	\$ –	\$ (1,344)
Lesser of:			
Expected to be recognized within three years (10eii(a)) or	(133)	–	(133)
15% of adjusted capital and surplus (10eiii(b))	(339)	–	(339)
Adjusted gross DTAs offset against existing DTLs (10eiii)	(1,548)	–	(1,548)

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

Increased amount of admitted gross DTAs, admitted assets, adjusted statutory capital and surplus and total adjusted capital at December 31:

	SSAP 10R Par. 10.a.-10.c.	SSAP 10R Par. 10.e.	Increased Amount
<b>2011</b>			
Admitted gross DTA	\$ 33,138	\$ 48,659	\$ 15,521
Admitted assets	954,619	970,140	15,521
Adjusted statutory capital and surplus	270,772	286,293	15,521
Total adjusted capital including DTAs	270,772	286,293	15,521
<b>2010</b>			
Admitted gross DTA	32,728	51,679	18,951
Admitted assets	990,120	1,009,071	18,951
Adjusted statutory capital and surplus	275,105	294,056	18,951
Total adjusted capital including DTAs	275,105	294,056	18,951
<b>Change</b>			
Admitted gross DTA	410	(3,020)	(3,430)
Admitted assets	(35,501)	(38,931)	(3,430)
Adjusted statutory capital and surplus	(4,333)	(7,763)	(3,430)
Total adjusted capital including DTAs	(4,333)	(7,763)	(3,430)

Deferred tax liabilities have been recognized for all taxable temporary differences.

The following are provisions for current tax expense for the years ended December 31:

	2011	2010	Change
Current domestic income tax expense	\$ 26,691	\$ 24,669	\$ 2,022
Current foreign income tax expense	1,600	951	649
Total current income tax expense	\$ 28,291	\$ 25,620	\$ 2,671

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

The change in net deferred income taxes is comprised of the following (exclusive of non-admitted deferred tax assets):

	<b>December 31</b>		
	<b>2011</b>	<b>2010</b>	<b>Change</b>
Total DTA	\$ 48,659	\$ 51,795	\$ (3,136)
Total DTL	(14,711)	(13,359)	(1,352)
Net DTA	<u>\$ 33,948</u>	<u>\$ 38,436</u>	<u>(4,488)</u>
Tax effect of cumulative translation adjustment			(715)
Tax effect of unrealized gains (losses)			(68)
Change in net deferred income tax			<u>\$ (5,271)</u>
Changes in admitted DTA under SSAP			
No. 10R reported as surplus write-in	\$ (3,430)	\$ (1,268)	

Non-admitted DTA decreased by \$116 and \$1,660 for 2011 and 2010, respectively.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

The provision for federal taxes is different from that which would be obtained by applying the statutory federal income tax rate to income from operations before federal income taxes. The significant items causing this difference for the years ended December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Provision calculated at statutory rate	\$ 35,169	\$ 35,042
Tax-exempt interest and dividends	(1,018)	(714)
Other permanent differences	104	848
Change in deferred taxes on non-admitted assets	591	(1,903)
Adjustment of prior year taxes	(1,044)	202
Tax differential on foreign earnings	1,600	951
Other	(38)	420
Foreign tax credit	(1,802)	(876)
Total	<u>\$ 33,562</u>	<u>\$ 33,970</u>

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

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

	2011		
	Ordinary	Capital	Total
DTA:			
Unearned premium reserves	\$ 36,059	\$ —	\$ 36,059
Unpaid loss reserve discounting	485	—	485
Investments	-	5	5
Non-admitted assets	12,094	—	12,094
Other	16	—	16
Total DTA	48,654	5	48,659
DTL:			
Investments	—	(827)	(827)
Unrealized foreign exchange gains	(6,310)	—	(6,310)
Property, plant, and equipment (PP&E) basis differences	(6,365)	—	(6,365)
Other	(1,209)	—	(1,209)
Total DTL	(13,884)	(827)	(14,711)
Net DTA	34,770	(822)	33,948
DTA non-admitted	—	—	—
Net admitted DTA	\$ 34,770	\$ (822)	\$ 33,948

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

5. Federal Income Taxes (continued)

	2010		
	Ordinary	Capital	Total
DTA:			
Unearned premium reserves	\$ 38,502	\$ –	\$ 38,502
Unpaid loss reserve discounting	522	–	522
Investments	–	70	70
Non-admitted assets	12,685	–	12,685
Other	16	–	16
Total DTA	51,725	70	51,795
DTL:			
Investments	–	(76)	(76)
Unrealized foreign exchange gains	(6,286)	–	(6,286)
(PP&E) basis differences	(5,895)	–	(5,895)
Other	(1,102)	–	(1,102)
Total DTL	(13,283)	(76)	(13,359)
Net DTA	38,442	(6)	38,436
DTA non-admitted	(46)	(70)	(116)
Net admitted DTA	\$ 38,396	\$ (76)	\$ 38,320

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

5. Federal Income Taxes (continued)

	Change		
	Ordinary	Capital	Total
DTA:			
Unearned premium reserves	\$ (2,443)	\$ –	\$ (2,443)
Unpaid loss reserve discounting	(37)	–	(37)
Investments	–	(65)	(65)
Non-admitted assets	(591)	–	(591)
Other	–	–	–
Total DTA	(3,071)	(65)	(3,136)
DTL:			
Investments	–	(751)	(751)
Unrealized foreign exchange gains	(24)	–	(24)
(PP&E) basis differences	(470)	–	(470)
Other	(107)	–	(107)
Total DTL	(601)	(751)	(1,352)
Net DTA	(3,672)	(816)	(4,488)
DTA non-admitted	46	70	116
Net admitted DTA	\$ (3,626)	\$ (746)	\$ (4,372)

The components of change in DTAs and DTLs and the current income tax benefit (expense) are as follows:

	2011	2010
Change in DTA	\$ 5,271	\$ 8,882
Tax effect of prior period correction of error	–	(532)
Net change in deferred taxes	5,271	8,350
Current income tax expense	28,291	25,620
Total statutory income tax expense	\$ 33,562	\$ 33,970

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**5. Federal Income Taxes (continued)**

The Company incurred federal income taxes available for recoupment in the event the Company incurs future net losses totaling \$27,525 for 2011 and \$25,237 for 2010.

TWG's consolidated tax return group is currently under IRS audit for the 2010 tax year.

The Company did not recognize a liability for unrecognized tax benefits and does not expect the unrecognized tax position to change significantly over the next 12 months.

The Company elected to recognize interest and penalties related to unrecognized income tax benefits in its provision for income taxes as incurred. As of December 31, 2011 and 2010, the Company had no recorded liabilities for penalties and interest.

There was no impact on the determination of adjusted gross DTAs and the determination of net admitted DTAs as a result of tax planning strategies for 2011 and 2010.

The Company is a member of The Warranty Group, Inc. U.S. consolidated tax group. The method of tax allocation between the companies is subject to a written agreement approved by the Department. The consolidated tax liability is generally allocated among the members of the group as if each member filed its own tax return. Generally, benefits are recorded as if a taxable loss can be used by the group.

**6. Reinsurance**

Certain premiums and losses are assumed from and ceded to other insurance companies under various reinsurance agreements. The ceded reinsurance agreements provide the Company with increased capacity to write larger risks and maintain its exposure to loss within its capital resources.

The Company remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations. Certain of these agreements provide excess loss coverage and are subject to contingent commission adjustments.



Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

**6. Reinsurance (continued)**

The effects of reinsurance on premiums written and earned for the years ended December 31 are as follows:

	2011		2010	
	Written	Earned	Written	Earned
Direct premiums	\$ 467,793	\$ 410,578	\$ 404,345	\$ 425,710
Assumed premiums:				
Affiliate	43,849	38,686	37,964	40,327
Non-affiliate	63,323	56,364	56,091	41,088
Ceded premiums	(282,773)	(180,740)	(215,232)	(157,906)
Net premiums	<u>\$ 292,192</u>	<u>\$ 324,888</u>	<u>\$ 283,168</u>	<u>\$ 349,219</u>

The Company's ceded reinsurance arrangements reduced certain other items in the accompanying statutory-basis financial statements as follows:

	2011	2010
Losses and loss adjustment expenses incurred	\$ 145,517	\$ 90,779
Loss and loss adjustment expense reserves*	346,264	373,585
Unearned premium reserves*	458,890	356,848

\*At year-end.

The Company has entered into three loss portfolio transfer (LPT) transactions that are reported in the accompanying statutory-basis statements of income. Two of the LPTs ceded all assets and liabilities related to their property and casualty (non-warranty) business to two third-party insurers. One of these LPT transactions is accounted for as prospective reinsurance, while the other LPT transaction is accounted for as retrospective reinsurance based on guidance applicable for statutory-basis reporting. Both of these LPT transactions are treated as prospective reinsurance under GAAP. The Company has received an indemnification from another third party for any future development on reserves or nonperformance of other third-party reinsurers on these LPT transactions. The third LPT resulted in the Company assuming from a third-party insurer all assets and liabilities related to certain extended warranty contracts.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**6. Reinsurance (continued)**

The following is a rollforward of activity related to the property and casualty (P&C) LPT accounted for as retrospective reinsurance:

	<u>Loss Reserves</u>
Balance at January 1, 2010	\$ 201,805
Paid losses recovered	(41,885)
Additional claims incurred:	
Prior years	9,377
Current year	—
Balance at December 31, 2010	<u>169,297</u>
Paid losses recovered	(26,799)
Additional claims incurred (redundancies):	
Prior years	(31,047)
Current year	—
Balance at December 31, 2011	<u><u>\$ 111,451</u></u>

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
(Dollars in Thousands)

**6. Reinsurance (continued)**

The following is the activity related to other assumed and ceded retroactive reinsurance agreements:

	Loss Reserves		Unearned Premium Reserves		Total	
	Assumed	Ceded	Assumed	Ceded	Assumed	Ceded
Balance at January 1, 2010	\$ 66	\$ 593	\$ 3,213	\$ 5,970	\$ 3,279	\$ 6,563
Paid losses recovered	(1,304)	(5,394)	–	–	(1,304)	(5,394)
Additional claims incurred:						
Prior years	–	–	–	–	–	–
Current year	1,309	5,451	–	–	1,309	5,451
Reduction in unearned premiums	–	–	(1,381)	1,286	(1,381)	1,286
Balance at December 31, 2010	71	650	1,832	7,256	1,903	7,906
Paid losses recovered	(780)	(3,698)	–	–	(780)	(3,698)
Additional claims incurred:						
Prior years	–	–	–	–	–	–
Current year	758	3,922	–	–	758	3,922
Reduction in unearned premiums	–	–	(943)	(958)	(943)	(958)
Balance at December 31, 2011	\$ 49	\$ 874	\$ 889	\$ 6,298	\$ 938	\$ 7,172

Unsecured reinsurance recoverables that exceed 3% of the Company's capital and surplus at December 31, 2011, are summarized as follows:

Name of Reinsurer	
Westport Insurance Corporation	\$ 65,430
National Indemnity Company	36,594
National Workers Comp Reins Pool	26,734
Endurance Reins Corp of America	26,537
Odyssey America Reins Co.	15,355
Aspen Insurance UK Ltd.	13,241
Berkley Ins Co.	13,113
Arch Ins Co.	11,765
QBE Reinsurance Corporation	9,765

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**6. Reinsurance (continued)**

The Company has been indemnified for future development on losses and loss adjustment expenses and any uncollectible reinsurance recoverables from all of these reinsurers.

The maximum amount of return commission that would have been due reinsurers had all the Company's ceded reinsurance been canceled was \$7,536 at December 31, 2011. Had the Company canceled its assumed reinsurance at December 31, 2010, \$4,834 in ceding commission would have been recoverable.

All reinsurance contracts with adjustable features (e.g., retrospectively-rated premiums, contingent, sliding scale and profit commissions) have been analyzed and any required adjustments have been properly recorded.

**7. Losses and Loss Adjustment Expenses**

The following table provides a reconciliation of the beginning and ending reserves for losses and loss adjustment expenses (LAE), net of reinsurance recoverables, for 2011 and 2010:

	P&C	Warranty	Total
<b>2011</b>			
Reserves for losses and LAE, at beginning of year	\$ 169,297	\$ 46,362	\$ 215,659
Add provision for claims occurring in:			
Current year	–	190,014	190,014
Prior years	(31,047)	(7,239)	(38,286)
Net incurred losses during the current year	(31,047)	182,775	151,728
Deduct payments for claims occurring in:			
Current year	–	158,745	158,745
Prior years	26,799	27,340	54,139
Net claim payments during the current year	26,799	186,085	212,884
Reserve for losses and LAE, at end of year	\$ 111,451	\$ 43,052	\$ 154,503

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

7. Losses and Loss Adjustment Expenses (continued)

	P&C	Warranty	Total
<b>2010</b>			
Reserves for losses and LAE, at beginning of year	\$ 201,805	\$ 38,084	\$ 239,889
Add provision for claims occurring in:			
Current year	–	220,084	220,084
Prior years	9,377	3,268	12,645
Net incurred losses during the current year	9,377	223,352	232,729
Deduct payments for claims occurring in:			
Current year	–	184,776	184,776
Prior years	41,885	30,298	72,183
Net claim payments during the current year	41,885	215,074	256,959
Reserve for losses and LAE, at end of year	\$ 169,297	\$ 46,362	\$ 215,659

Since the reserves net for losses and loss adjustment expenses include estimates developed from various actuarial methods, the Company's actual losses incurred may be more or less than the Company's previously developed estimates. Certain of the Company's arrangements with producers of warranty contracts include profit-sharing provisions whereby the redundancy or deficiency in reserves noted in the above table would be paid out or reduce payments to the producer in the form of a profit commission. The 2011 redundancy primarily relates to the Company's run-off P&C business. During 2011, the Company experienced favorable claim development on certain outstanding years' claims, and as a result, causing the release of certain reserves. As the Company's P&C business is ceded to various third-party reinsurers, the changes in claim development do not impact the Company's financial position. Redundancies and deficiencies in the P&C block of business are subject to a loss portfolio transfer and are guaranteed by a third party. Development on these reserves has no impact on income.

During 2011, the Company paid \$106 for extra contractual obligations and bad faith losses stemming from lawsuits on four claims. No payment was made in 2010 related to extra contractual obligations.

## Virginia Surety Company, Inc.

### Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

#### **8. Related-Party Transactions**

The Company has entered into administrative services agreements with its affiliated companies. Pursuant to these agreements, various administrative, management, and support services are provided to or provided by the Company. The expenses related to these administrative, management, and support services are allocated to or allocated by the Company in amounts equal to the direct and indirect costs and expenses incurred in providing these services. Direct costs include expenses such as salaries, benefits, communications, advertising, consulting services, maintenance, rent, utilities, and supplies, which are directly attributable to the operations of the Company. Allocated costs include expense such as salaries, benefit claims and enrollment processing, billing, accounting, underwriting, product development, and budgeting, which support the operations of the Company. These costs are allocated based on various utilization statistics.

Net amounts allocated from affiliated companies pursuant to the above administrative services agreements were \$29,967 and \$30,469 in 2011 and 2010, respectively, and are included in other underwriting expenses incurred and loss and loss adjustment expenses incurred in the statutory-basis statements of income.

At December 31, 2011 and 2010, the Company reported \$3,877 and \$2,515 due from affiliates and \$2,453 and \$1,268 due to affiliates, respectively. Amounts due from affiliates non-admitted as of December 31, 2011 and 2010, were \$11,212 and \$14,075, respectively.

The Company insures losses associated with certain of the warranty agreements written by its affiliated companies. Additionally, the Company has issued contractual liability policies and failure to perform endorsements to affiliated companies.

#### **9. Capital and Surplus**

The Company is subject to certain minimum surplus requirements of the Illinois Insurance Code. Additionally, insurance companies are subject to certain risk-based capital (RBC) requirements as specified by the NAIC. Under those requirements, the required amount of capital and surplus of an insurance company is determined based on the various risk factors related to it. The Company met the RBC requirements at December 31, 2011.

The Company has 5,000,000 shares of \$1 par value common stock authorized, issued, and outstanding. The Company has no preferred stock authorized, issued, or outstanding.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)  
*(Dollars in Thousands)*

**9. Capital and Surplus (continued)**

The payment of dividends by the Company to its Parent is limited and can only be made from earned profits unless prior approval is received from the Department. Under the insurance regulations of the state of Illinois, the maximum amount of dividends that the Company may pay to its Parent during any twelve-month period without the prior approval of the Department is limited to the greater of 10% of the most recent year-end capital and surplus or net income of the most recently completed year as reported in the Company's annual statement. Approximately \$72,193 is available for dividend payments in 2012 without prior written approval of the Department. In December 2010, the Company filed a request with the Department to its parent for an extraordinary dividend payment which was approved. The Company paid an ordinary dividend of \$74,000 in 2011 and an extraordinary dividend of \$65,000 in 2010.

**10. Employee Benefits**

TWG sponsors a plan to provide retirees age 55 or older with more than 15 years of service access to TWG medical plan at subsidized rates. VSC was allocated \$74 and \$77 related to benefits provided under this plan during the years ended December 31, 2011 and 2010, respectively, which was included in the Company's statutory-basis statements of income.

TWG also sponsors a defined contribution 401(k) savings plan (Savings Plan) for its employees. The Savings Plan is a voluntary contributory plan under which employees may elect to defer compensation for federal income tax purposes under Section 401(k) of the Internal Revenue Code of 1986. Employees can elect to make pre-tax or after-tax contributions ranging from 1% to 25% of their compensation. After one year of service, TWG will match 50% of the employee's contributions subject to a maximum of 6% of the employee's salary. An employee's interest in TWG's matching contributions vest at a rate of 20% per plan year. The matching contributions to the Savings Plan allocated to VSC were \$274 and \$266 for the years ended December 31, 2011 and 2010, respectively.

Virginia Surety Company, Inc.

Notes to Financial Statements – Statutory Basis (continued)

*(Dollars in Thousands)*

**10. Employee Benefits (continued)**

Prior to December 31, 2011, TWG supplemented the Savings Plan with additional discretionary retirement contributions that were funded entirely by TWG as determined by the Board of Directors. This program was terminated effective December 31, 2011. All eligible active employees who worked over 1,000 hours during the plan year and were employed on the last day of the plan year shared in this additional retirement contribution. An employee became vested in the additional TWG contributions after three years of service during which the employee worked 1,000 hours each year. An employee also became vested when they reach retirement age as long as they are still employed by the Company. Total incurred expenses for the years ended December 31, 2011 and 2010, allocated to VSC were \$0 and \$597, respectively.

The Company also had a supplemental executive retirement plan (SERP) that allowed certain executives to supplement existing retirement benefits offered under the Savings Plan by removing or increasing the limits imposed under the qualified plan rules. The supplemental executive retirement account contribution was eliminated for the 2011 plan year. The total expenses allocated to VSC in 2011 and 2010 related to the SERP was \$0 and \$40, respectively.

**11. Third-Party Administrators**

The Company utilizes third-party administrators in its operations. Premiums written by those third-party administrators that exceeded 5% of the Company's statutory-basis capital and surplus were \$129,509 and \$61,795 in 2011 and 2010, respectively.



# Virginia Surety Company, Inc.

## Notes to Financial Statements – Statutory Basis (continued)

(Dollars in Thousands)

### 11. Third-Party Administrators (continued)

The Company has the following aggregate amount of direct premiums written through administrators:

NAME AND ADDRESS Managing General Agent or Third Party Administrator	FEI Number	Exclusive Contract	Type of Business Written	Type of Authority Granted	Direct Written Premium
Safe-Guard Products International, LLC 3500 Piedmont Rd. Suite 400 Atlanta, GA 30305	58-2014424	No	Warranty Related	P, C	\$ 95,910
Express Systems, Inc. 11 Vanderbilt Rd Irvine, CA 92618	33-0620692	No	Warranty Related	P, C	17,751
National Electronics Warranty 22894 Pacific Blvd., P.O. Box 1237 Sterling, VA 20166	52-1356309	No	Warranty Related	C, CA, P	15,848

#### Type of Authority Granted

C – Claims Payment  
CA – Claims Adjustment  
P – Premium Collection

### 12. Uninsured Plans

Uninsured plans consist primarily of claims processed on behalf of certain credit card and personal computer companies where the Company has determined that there is no insurance risk transfer. The total claim payment volume for uninsured plan contracts for the years ended December 31, 2011 and 2010 was \$12,442 and \$6,614, respectively.

The net gain from operations from uninsured plans for the year ended December 31, was as follows:

	2011	2010
Gross reimbursement for claims incurred	\$ 12,442	\$ 6,614
Gross administrative fees accrued	2,843	525
Gross expenses incurred (claims and administrative)	30	24
Total net gain from uninsured plans	2,813	501

## Virginia Surety Company, Inc.

### Notes to Financial Statements – Statutory Basis (continued) (Dollars in Thousands)

#### **13. Commitments and Contingencies**

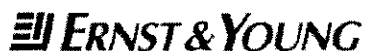
The Company and its subsidiaries are subject to numerous claims and lawsuits that arise in the ordinary course of business. The damages that may be claimed are substantial, including in many instances claims for punitive or extraordinary damages. Accruals for these items have been provided to the extent that losses are deemed probable and are estimable.

Although the ultimate outcome of these matters cannot be ascertained and liabilities in indeterminate amounts may be imposed on the Company or its subsidiaries, on the basis of present information and availability of insurance coverages, it is the opinion of management that the disposition or ultimate determination of such claims will not have a material adverse effect on the financial position of the Company. However, it is possible that future results of operations or cash flows for any particular quarterly or annual period could be materially affected by an unfavorable resolution of these matters.

During 2011, TWG engaged outside counsel to conduct an internal investigation and review focused on compliance with the Foreign Corrupt Practices Act (FCPA) and related U.S. and foreign laws in Malaysia and additional countries. The internal investigation, which is being conducted under the oversight of TWG's Audit Committee, began in March 2011. TWG has voluntarily contacted the United States Department of Justice (USDOJ) to advise them of the internal investigation. TWG continues to cooperate with the USDOJ and is responding to any inquiries made by them. The Company is presently unable to predict the duration, scope, developments in, results, or consequences of the internal investigation and reviews or the USDOJ impact.

#### **14. Correction of Error**

During 2010, the Company discovered an error in the reporting of its unearned premium reserve (UPR) balance related to a foreign operation. As a result of the error, the December 31, 2009, statutory-basis balance sheet contained the following errors: liabilities for UPR were understated by \$7,590 and surplus was overstated by \$7,058, net of tax. This adjustment was recorded as a direct adjustment to the UPR and capital and surplus as of January 1, 2010.



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## Report of Independent Auditors on Supplementary Information

The Board of Directors  
Virginia Surety Company, Inc.

Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements taken as a whole. The accompanying supplemental schedule of selected statutory-basis financial data, supplemental investment, and reinsurance disclosures are presented to comply with the National Association of Insurance Commissioner's *Annual Statement Instructions* and the National Association of Insurance Commissioner's *Accounting Practices and Procedures Manual* and for purposes of additional analysis and are not a required part of the statutory-basis financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in our audit of the statutory-basis financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the statutory-basis financial statements as a whole.

This report is intended solely for the information and use of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

*Ernst & Young LLP*

May 23, 2012

Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis  
(Dollars in Thousands)

December 31, 2011

1. The Company's total admitted assets as reported in the annual statement are \$970,140.
2. Following are the 10 largest exposures to a single issuer/borrower/investment, by investment category excluding: (i) U.S. government, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the SVO's *Purposes and Procedures Manual* as exempt; (ii) property occupied by the Company; and (iii) policy loans.

Issuer	Amount	Percentage of Total Admitted Assets
Government of Malaysia	\$ 20,049	2.07%
Blackrock	17,474	1.80
Government of Canada	17,359	1.79
Santander Drive Auto Receivables Trust	15,039	1.55
Banco Finansur SA	12,962	1.34
Banco CMF SA	11,844	1.22
Bear Stearns	11,477	1.18
Banco De Servicios Y Transacciones SA	11,288	1.16
Commonwealth of Australia	9,979	1.03
Nomura	9,219	0.95

3. The Company's total admitted assets held in bonds and short-term investments by NAIC rating at December 31, 2011, were:

Bonds and Short-Term Investments		
NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	\$ 739,009	76.18%
NAIC-2	44,466	4.58
NAIC-3	5,449	0.56
NAIC-4	2,665	0.27
	<u>\$ 791,589</u>	

Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis (continued)  
(Dollars in Thousands)

4. As of December 31, 2011, the Company's total admitted assets held in foreign investments of \$159,073, excluding Canadian investments and currency exposure of \$38,365 (regardless of whether there is any foreign currency exposure) of which \$135,855 of foreign currency-denominated investments which supports \$132,392 consisted of foreign currency-denominated insurance liabilities in these same foreign currencies.
5. Aggregate foreign investment exposure categorized by NAIC's sovereign rating:

	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Countries rated NAIC-1	\$ 114,226	11.77%
Countries rated NAIC-2	—	—
Countries rated NAIC-3 or below	44,847	4.62

6. Two largest foreign investment exposures by country, if applicable, categorized by the country's NAIC sovereign rating:

	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Countries rated NAIC-1:		
Country: Australia	\$ 51,609	5.32%
Country: Malaysia	25,890	2.67
Countries rated NAIC-2:		
Country:	—	—
Countries rated NAIC-3 or below:		
Country: Argentina	44,847	4.62

Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis (continued)  
(Dollars in Thousands)

7. Aggregate unhedged foreign currency exposure: \$68,864 or 7.10% of total admitted assets.

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating:

	<b>Amount</b>	<b>Percentage of Total Admitted Assets</b>
Countries rated NAIC-1	\$ 24,116	2.49%
Countries rated NAIC-2	—	—
Countries rated NAIC-3 or below	44,748	4.61

9. Two largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign rating:

	<b>Amount</b>	<b>Percentage of Total Admitted Assets</b>
Countries rated NAIC-1:		
Country: Korea	\$ 9,512	0.98%
Country: Australia	8,990	0.93
Countries rated NAIC-2	—	—
Countries rated NAIC-3 or below:		
Country: Argentina	44,748	4.61

Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis (continued)

(Dollars in Thousands)

10. Ten largest non-sovereign (i.e., nongovernmental) foreign issues:

	<b>Amount</b>	<b>Percentage of Total Admitted Assets</b>
Banco Finansur SA	\$ 12,962	1.34%
Banco CMF SA	11,844	1.22
Banco De Servicios Y Transacciones SA	11,288	1.16
HSBC Korea	9,512	0.98
National Australia Bank Limited	8,990	0.93
Banco Industrial SA	7,084	0.73
BHP Billiton Finance (USA) Limited	4,041	0.42
Diageo Capital PLC	3,929	0.41
Westpac New Zealand Limited	2,886	0.30
Australia and New Zealand Banking Group Ltd	2,046	0.21

11. The Company's total admitted assets held in Canadian investments and unhedged Canadian currency exposure, including Canadian currency-denominated investments of \$38,365 supporting Canadian currency-denominated insurance liabilities at December 31, 2011, are:

	<b>Amount</b>	<b>Percentage of Total Admitted Assets</b>
Canadian currency denominated investments	\$ 29,616	3.05%
Unhedged Canadian currency exposure	6,351	0.66
Canadian denominated insurance liability	12,840	1.32

12. The aggregate amount and percentages of the Company's total admitted assets held in investment with contractual sales restrictions (defined as investment having restrictions that prevent investments from being sold within 90 days) are: None

Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis (continued)

(Dollars in Thousands)

13. The Company's admitted assets held in the largest 10 equity interests, including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities (including schedule BA equity interests) and excluding money market and bond mutual funds listed in the Appendix to the SVO's *Purposes and Procedures Manual* as exempt or Class (1) at December 31, 2011, are:

Investment Category	Amount	Percentage of Total Admitted Assets
HSBC Investor Funds	\$ 2,483	0.26%
Westpac Banking	1,170	0.12

14. Assets held in nonaffiliated, private placed equities are less than 2.5% of the Company's total admitted assets.
15. Assets held in general partnership interest are less than 2.5% of the Company's total admitted assets.
16. Mortgage loans reported in Schedule B are less than 2.5% of the Company's total admitted assets.
17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date: None
18. The five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of the Company's total admitted assets.
19. Assets held in mezzanine real estate loans are less than 2.5% of the Company's total admitted assets.
20. The Company did not have any admitted assets, as of December 31, 2011, or during 2011, subject to the following types of agreements: securities lending, repurchase agreements, reverse repurchase agreements, dollar repurchase agreements, and dollar reverse repurchase agreements.
21. The Company did not own any assets with warrants not attached to other financial instruments, options, caps, and floors as of December 31, 2011, or during 2011.



Virginia Surety Company, Inc.

Investment Risks Interrogatories – Statutory Basis (continued)  
(Dollars in Thousands)

22. The Company did not own any assets with potential exposure for collars, swaps, and forwards as of December 31, 2011, or during 2011.
23. The Company did not own any assets with potential exposure (defined as the amount determined in accordance with the NAIC's *Annual Statement Instructions*) for futures contracts as of December 31, 2011, or during 2011.

Virginia Surety Company, Inc.

Reinsurance Interrogatories – Statutory Basis  
(Dollars in Thousands)

December 31, 2011

1. Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)?  
Yes ☒ No ☐
2. If yes, indicate the number of reinsurance contracts containing such provisions: 26
3. If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provisions?  
Yes ☒ No ☐
4. Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contracts contain one or more of the following features or other features that would have similar results:  
Yes ☒ No ☐
  - (a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
  - (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
  - (c) Aggregate stop loss reinsurance coverage;

Virginia Surety Company, Inc.

Reinsurance Interrogatories – Statutory Basis (continued)  
(Dollars in Thousands)

- (d) A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions that are only triggered by a decline in the credit status of the other party;
  - (e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
  - (f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.
5. Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which, during the period covered by the statement, it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards to policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves greater than 5% of prior year-end surplus as regards to policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with: (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

Yes [X] No [ ]

- (a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available statutory-basis financial statement; or
- (b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in a separate reinsurance contract.

Virginia Surety Company, Inc.

Reinsurance Interrogatories – Statutory Basis (continued)  
(Dollars in Thousands)

6. If yes to 4 or 5, please provide the following information:

- (a) The aggregate statutory-basis financial statement impact gross of all such ceded reinsurance contracts on the statutory-basis balance sheet and statutory-basis statement of income;
- (b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 4 or 5; and
- (c) A brief discussion of management's principle objectives in entering into the reinsurance contract including the economic purpose to be achieved.

Reinsurer	As Reported	Reinsurance Effect	Restated Without Reinsurance
<b>1) Asset Insurance Company, Ltd.<sup>(B)</sup></b>			
Assets	\$ 970,140	\$ 55,651	\$ 1,025,791
Liabilities	683,847	55,651	739,498
Capital and surplus	286,293	12,495	298,788
Underwriting income	100,484	12,495	112,979
Management's objective	Cede risk to reinsurance captive		

Reinsurer	As Reported	Reinsurance Effect	Restated Without Reinsurance
<b>2) Express Performance, Ltd.<sup>(A)</sup></b>			
Assets	\$ 970,140	\$ 19,090	\$ 989,230
Liabilities	683,847	19,090	702,937
Capital and surplus	286,293	3,006	289,299
Underwriting income	100,484	3,006	103,490
Management's objective	Cede risk to reinsurance captive		

Virginia Surety Company, Inc.

Reinsurance Interrogatories – Statutory Basis (continued)

(Dollars in Thousands)

<b>Reinsurer</b>	<b>As Reported</b>	<b>Reinsurance Effect</b>	<b>Restated Without Reinsurance</b>
<b>3) Glendale Insurance Company<sup>(B)</sup></b>			
Assets	\$ 970,140	\$ 38,964	\$ 1,009,104
Liabilities	683,847	38,964	722,811
Capital and surplus	286,293	7,393	293,686
Underwriting income	100,484	7,383	107,867
Management's objective	Cede risk to reinsurance captive		

<b>Reinsurer</b>	<b>As Reported</b>	<b>Reinsurance Effect</b>	<b>Restated Without Reinsurance</b>
<b>4) Kenwood Insurance Company<sup>(B)</sup></b>			
Assets	\$ 970,140	\$ 83,193	\$ 1,053,333
Liabilities	683,847	83,193	767,040
Capital and surplus	286,293	15,786	302,079
Underwriting income	100,484	15,786	116,270
Management's objective	Cede risk to reinsurance captive		

<b>Reinsurer</b>	<b>As Reported</b>	<b>Reinsurance Effect</b>	<b>Restated Without Reinsurance</b>
<b>5) Safe-guard Reinsurance Company<sup>(A)</sup></b>			
Assets	\$ 970,140	\$ 93,296	\$ 1,063,436
Liabilities	683,847	93,296	777,143
Capital and surplus	286,293	2,835	289,128
Underwriting income	100,484	2,835	103,319
Management's objective	Cede risk to reinsurance captive		

Virginia Surety Company, Inc.

Reinsurance Interrogatories – Statutory Basis (continued)

(Dollars in Thousands)

The reinsurance effect in this interrogatory on surplus is show as the underwriting income (loss) for the year ended December 31, 2011, as it is assumed that any prior surplus would have been distributed to policyholders.

**Reinsurance Contract Terms Key**

(A) 100% Quota-share, Included due to >50% of Reinsurers Premiums come from the Company.

(B) 100% Quota-share (25% Funds Held) of Business to Reinsurer, Loss Corridor 120% to 165% or 180%, Included due to >50% of Reinsurer's Premiums come from the Company.

7. Except for transactions meeting the requirements of paragraph 31 of SSAP No. 62R, Property and Casualty Reinsurance, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the statutory-basis financial statement, and either:

Yes ☐ No ☒

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP?

8. If yes to 7, explain why the contract(s) is treated differently for GAAP and SAP.

Yes ☐ No ☐ N/A ☒

Virginia Surety Company, Inc.

Summary Investment Schedule – Statutory Basis  
(Dollars in Thousands)

December 31, 2011

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statements	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Gross Investment Holdings
Bonds:				
U.S. treasury securities	\$ 7,206	0.8%	\$ 7,206	0.8%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government sponsored agencies	1,991	0.2	1,991	0.2
Non-U.S. government (including Canada, excluding mortgage-backed securities)	94,590	10.8	94,590	10.8
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	13,390	1.5	13,390	1.5
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	25,198	2.9	25,198	2.9
Revenue and assessment obligations	79,883	9.1	79,883	9.1
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities issued or guaranteed by GNMA	3,007	0.3	3,007	0.3
FNMA and FHLMC	64,900	7.4	64,900	7.4
Pass-through securities – all other				
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	116,870	13.4	116,870	13.4
Issued by non-U.S. Government issuers and collateralized by mortgage-backed securities issued or guaranteed by agencies	1,907	0.2	1,907	0.2
All other	85,124	9.7	85,124	9.7
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	253,142	28.9	253,142	28.9
Unaffiliated non-U.S. securities (including Canada)	23,722	2.7	23,722	2.7
Equity interests:				
Investments in mutual funds	3,755	0.4	3,755	0.4
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated				
Cash, cash equivalents, and short-term investments	102,128	11.7	102,128	11.7
Total invested assets	\$ 876,813	100.0 %	\$ 876,813	100.0 %

\*Gross investment holdings as valued in compliance with the NAIC's *Accounting Practices and Procedures Manual*.

Virginia Surety Company, Inc.

Note to Supplementary Information – Statutory Basis

December 31, 2011

**Note – Basis of Presentation**

The accompanying supplemental reinsurance interrogatories and supplemental investment schedules present selected statutory-basis financial data as of December 31, 2011, and for the year then ended, for the purpose of complying with the National Association of Insurance Commissioners' *Annual Statement Instructions* and National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agree to or are included in the amounts reported in the Company's 2011 Statutory Annual Statement as filed with the Illinois Department of Insurance.

Captions or amounts that are not applicable have been omitted.



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