# CITADEL REINSURANCE COMPANY LIMITED

**Consolidated Financial Statements**
(With Independent Auditors' Report Thereon)

Years Ended December 31, 2011 and 2010

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
Citadel Reinsurance Company Limited

We have audited the accompanying consolidated balance sheets of Citadel Reinsurance Company Limited as of December 31, 2011 and 2010 and the related consolidated statements of income and comprehensive income, changes in shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citadel Reinsurance Company Limited as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG

Chartered Accountants
Hamilton, Bermuda
July 3, 2012

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Balance Sheets

December 31, 2011 and 2010
*(Expressed in United States Dollars)*

| | As at December 31, | |
| --- | --- | --- |
| | 2011 | 2010 |
| **ASSETS** | | |
| Marketable securities (Note 4) | $ 26,982,811 | $ 20,072,491 |
| Cash and cash equivalents | 11,822,626 | 9,450,594 |
| Restricted cash (Note 11) | 515,099 | 2,890,031 |
| Accounts receivable and accrued interest | 2,645,991 | 1,972,163 |
| Reinsurance balances receivable | 1,808,879 | 367,364 |
| Deposit assets (Note7) | 50,679,234 | 48,971,860 |
| Deferred underwriting expenses | 410,518 | 29,901 |
| Goodwill (Note 5) | 1,643,956 | 0 |
| Property, plant and equipment | 209,624 | 117,015 |
| **Total assets** | $ 96,718,738 | $ 83,871,419 |
| **LIABILITIES** | | |
| Loss and loss adjustment expense reserves (Note 6) | $ 11,097,829 | $ 3,182,658 |
| Unearned premiums | 2,965,283 | 403,729 |
| Insurance and reinsurance balances payable | 2,927,101 | 0 |
| Unearned service fee | 2,358,214 | 3,547,805 |
| Deposit liabilities (Note 8) | 50,679,234 | 48,971,860 |
| Accounts payable and accruals | 6,068,180 | 5,268,730 |
| **Total liabilities** | 76,095,841 | 61,374,782 |
| **EQUITY** | | |
| Share Capital (Note 9) | 20,000,000 | 20,000,000 |
| Retained earnings | 991,181 | 2,552,932 |
| **Total Citadel shareholder's equity** | 20,991,181 | 22,552,932 |
| **Noncontrolling interest in subsidiaries** | (368,284) | (56,295) |
| **Total equity** | 20,622,897 | 22,496,637 |
| **Total liabilities and equity** | $ 96,718,738 | $ 83,871,419 |

*See accompanying notes to consolidated financial statements*

Signed on behalf of the Board

Director

Director

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Statements of Operations

December 31, 2011 and 2010
*(Expressed in United States Dollars)*

| | For the years ended December 31, | |
|---|---|---|
| | **2011** | **2010** |
| **REVENUES** | | |
| Gross premiums written | $ 9,116,408 | $ 1,422,353 |
| Premiums ceded | (1,532,946) | 190 |
| Net premiums written | 7,583,462 | 1,422,543 |
| Change in net unearned premiums | (1,424,197) | 92,576 |
| Net premiums earned | 6,159,265 | 1,515,119 |
| Net investment income | (93,610) | 314,370 |
| Net realized and unrealized (losses) gains - investments | (217,518) | 563,430 |
| Other income | 3,533,902 | 3,606,118 |
| Total revenues | 9,382,039 | 5,999,037 |
| **EXPENSES** | | |
| Loss and loss adjustment expenses | 5,456,220 | 784,948 |
| Acquisition costs | 879,009 | 463,378 |
| General and administrative expenses | 5,234,119 | 3,908,190 |
| Net foreign exchange gains | (210,540) | (277,422) |
| Total expenses | 11,358,808 | 4,879,094 |
| (Loss) income before income taxes | (1,976,769) | 1,119,943 |
| Recovery (provision) for income tax (Note 13) | 103,030 | (146,409) |
| (Loss) income from continuing operations | (1,873,739) | 973,534 |
| Net (loss) income | (1,873,739) | 973,534 |
| Less: Loss (income) attributable to non-controlling interest | 311,989 | 56,295 |
| **NET (LOSS) INCOME ATTRIBUTABLE TO CITADEL** | $ (1,561,750) | $ 1,029,829 |

*See accompanying notes to consolidated financial statements*

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Statements of Changes in Shareholders' Equity

December 31, 2011 and 2010
*(Expressed in United States Dollars)*

| | | Shareholder's Equity | | |
|---|---|---|---|---|
| | **Total equity** | **Retained earnings** | **Share capital** | **Non-controlling interest in subsidiaries** |
| Balance at December 31, 2009 | $ 21,523,103 | $ 1,523,103 | $ 20,000,000 | $ - |
| Net income | 973,534 | 1,029,829 | - | (56,295) |
| Balance at December 31, 2010 | $ 22,496,637 | $ 2,552,932 | $ 20,000,000 | $ (56,295) |
| Net loss | (1,873,739) | (1,561,750) | - | (311,989) |
| Balance at December 31, 2011 | $ 20,622,897 | $ 991,181 | $ 20,000,000 | $ (368,284) |

*See accompanying notes to consolidated financial statements*

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Statements of Cash Flows

December 31, 2011 and 2010
*(Expressed in United States Dollars)*

| | For the years ended December 31, 2011 | 2010 |
|---|---|---|
| **Cash flows provided by (used in) operating activities:** | | |
| Net (loss) income | $ (1,873,739) | $ 973,534 |
| **Adjustments to reconcile net income (loss) to net cash provided by operating activities:** | | |
| Net realized and unrealized losses (gains) | 217,518 | (563,430) |
| Net unrealized foreign exchange (gains) losses | (224,865) | (190,171) |
| Depreciation expense | 64,465 | 23,532 |
| Changes in assets and liabilities, excluding net assets acquired: | | |
| Other investments | 0 | (147,756) |
| Accounts receivable and accrued interest | (673,828) | (647,353) |
| Reinsurance balances receivable | (1,441,515) | 171,216 |
| Deposit assets | (1,707,374) | 1,704,388 |
| Deferred underwriting expenses | (380,617) | 6,899 |
| Goodwill | (1,643,956) | 0 |
| Loss and loss adjustment expense reserves | 7,915,171 | 152,564 |
| Unearned premiums | 2,561,554 | (84,876) |
| Insurance and reinsurance balance s payable | 2,927,101 | (770) |
| Unearned service fee | (1,189,591) | (725,726) |
| Deposit liabilities | 1,707,374 | (1,704,388) |
| Accounts payable and accruals | 799,450 | (981,549) |
| Non-controlling interest | (311,989) | (56,295) |
| **Net cash (used in) provided by operating activities** | 6,745,159 | (2,070,181) |
| **Cash flows (used in) provided by investing activities:** | | |
| Proceeds on disposal of marketable securities | 13,623,856 | 6,057,457 |
| Purchases of marketable securities | (20,214,826) | (6,260,648) |
| Purchases of fixed assets | (157,089) | (78,594) |
| Change in restricted cash | 2,374,932 | (307,671) |
| **Net cash provided by (used in) investing activities** | (4,373,127) | (589,456) |
| Increase (decrease) in cash and cash equivalents | 2,372,032 | (2,659,637) |
| Cash and cash equivalents - beginning of year | 9,450,594 | 12,110,231 |
| **Cash and cash equivalents - end of year** | $ 11,822,626 | $ 9,450,594 |

*See accompanying notes to consolidated financial statements*

## 1. NATURE OF BUSINESS

Citadel Reinsurance Company Limited (the "Company"), which underwrites insurance and reinsurance, was incorporated under the laws of Bermuda on January 4, 1984 and is registered as a Class 3A insurer under The Insurance Act 1978, amendments thereto and related regulations ("The Act"). The Company is managed and has its principal place of business in Bermuda. The Company's ultimate parent company is Sirius International Limited, a company incorporated in Bermuda.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

These consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements in accordance with generally accepted accounting principles, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the balance sheet date. Estimates also affect the reported amounts of income and expenses for the reporting period. Actual results could differ from those estimates. The Company's principal estimates relate to the development or determination of the following:

- the valuation of investments and determination of hierarchical inputs used to measure fair value of investments;
- outstanding loss and loss expenses;
- premium revenue recognition;
- acquisition accounting.

### Consolidation

These financial statements include the operations of the Company and its wholly-owned subsidiaries, namely Citadel International Reinsurance Company Limited ("CIRCL"), Citadel Group Representatives Limited, Citadel Group Representatives, Inc, Citadel Risk Management, Inc, ("CRMI"), Citadel Risk Services, Inc. ("CRS") and Green Park (US) Incorporated. CIRCL is a segregated account company, incorporated in Bermuda. There are four segregated cells (2010 - three) within CIRCL, one of which has been consolidated into these financial statements on the basis that the Company owns 65% of the preferred shares of the cell. The remaining 35% of the cells's income is recognised as a minority interest. To the extent the cell has a deficiency in excess of its share capital the full amount of the deficiency is consolidated into these financial statements. To the extent that the cell's retained earnings exceed its share capital the non-controlling 35% interest is accrued on the balance sheet.

During 2010 the Company and CRS jointly acquired 64.44% of Great Falls Holding Company ("GFH"), a company incorporated in Delaware, U.S.A. GFH has a wholly owned subsidiary, Great Falls Insurance Company ("GFI"), which is engaged in the business of writing workers compensation insurance in the State of Maine, U.S.A. The operations of GFH and GFI have been consolidated in these financial statements on the basis that the Company owns 64.44% of the issued capital. The remaining 35.56% is recognised as a non-controlling interest.

During 2011 the Company incorporated a new wholly owned subsidiary, Citadel Risk Holdings, Inc. ("CRHI"). The Company and CRHI jointly acquired 100% of American Millennium Insurance Company ("AMIC") which is engaged in the business of writing commercial automobile liability insurance in the States of New Jersey, Pennsylvania and Oklahoma. At the same time, CRMI acquired 100% of Old Rock and First Brokers, brokerage operations connected to AMIC. The operations of AMIC, Old Rock and First Brokers have been consolidated in these financial statements.

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

### Premiums and Acquisition Costs

Premiums are written when received and net premiums are earned on a pro-rata basis over the term of the related policies. Written premiums comprise the premiums on contracts entered into during the accounting period and are disclosed gross of commission payable to intermediaries and exclude taxes and duties levied on premiums.

The provision for unearned premiums represents that portion of the premiums written in respect of the current and prior years, which is attributable to the unexpired term of the corresponding policy in force.

Acquisition costs are comprised of ceding commissions, brokerage, premium taxes, profit commissions and other expenses that relate directly to the writing of reinsurance contracts. Deferred acquisition costs are amortized over the underlying term of the related.

### Loss and Loss Adjustment Expense Reserves

The estimated liability for losses and loss adjustment expenses is determined from reports received from the Company ceding insurance business to the Company. Management reviews this loss information and establishes loss and loss expense reserves, including a reserve for losses incurred but not reported ("IBNR"). Loss estimates were derived from sound actuarial methods based on many items including but not limited to historical account data, industry data and pertinent pricing information.

Management believes that the reserve for losses and loss expenses at December 31, 2011 is adequate to cover the ultimate net cost of losses incurred, however, such liability is necessarily based on estimates and no representation is made that the ultimate liability may not exceed such estimates. Subsequent revisions to estimated ultimate losses will be reflected in operations in the period in which they are determined.

The establishment of the provision for losses and loss adjustment expenses is based upon known facts and interpretation of circumstances and is therefore a complex and dynamic process influenced by a large variety of factors. In establishing a provision for unpaid claims and claims expenses, management considers facts currently known, the current state of laws and litigation and current estimates of reported losses and loss expenses. Liabilities are recognized for known claims when sufficient information has been developed to indicate the involvement of a specific policy, and management can reasonably estimate the Company's liability. In addition, a provision for adverse development for reported notifications and incurred but not reported claims is recorded based on the recommendations of an independent actuary using the past loss history of the Company and industry data.

The Company has reduced its loss and loss expense provisions by discounting for the time value of money. The value of the discount at December 31, 2011 was $Nil (2010 - $4,408) using a discount rate of 0% (2010 - 3%). Assumed maturity dates range between December 31, 2013 and December 31, 2014.

### Deposit assets and deposit liabilities

For all insurance/reinsurance agreements where no risk is assumed by the Company, the Company records, in the consolidated statement of earnings, the net fee or margin earned as a result of the transactions. These fees are earned in accordance with the terms of the agreements.

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

The insurance/reinsurance assets and liabilities related to the agreements are recorded at their gross amounts in the balance sheet within Deposit assets and Deposit liabilities. The provision for claims reflected as part of the Deposit liabilities is discounted based upon the liability after taking account of the known duration of such liability, the rate of return on the matching assets and the future reductions in deferred underwriting expenses and the provision for unearned premiums.

### Cash and Cash Equivalents

Cash and cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

### Marketable securities

In accordance with the Financial Instruments Topic of the FASB ASC, the Company differentiates between "held to maturity" marketable securities, which are recognised at amortized cost, and "held for trading" marketable securities, which are recognised at market value with unrealised gains and losses being reported as other income in the consolidated statement of operations.

The Company may sell securities it does not own in anticipation of a decline in market value of that security. Upon entering a short position, the Company records the proceeds in cash and cash equivalents and establishes an offsetting accounts payable for the securities due under the short sale agreement, which is subsequently marked to market. The Company will generally borrow the security sold short in order to make delivery to a buyer and then replace the borrowed security by purchasing it at the market price at the time of replacement. Until the security is replaced, the Company is required to pay the lender any interest or dividend earned, which is recorded as a reduction of other income to the Company. The Company realises again if the security declines in price between the date of the short sale and the date on which the Company replaces the borrowed security and the Company incurs a loss as a result of the short sale if the price of the security increases. Realized and unrealized gains and losses arising from short sales of securities are included in other income. There were no short positions open at year end, and all short positions have been covered.

### Goodwill

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired by the Company. Goodwill is recorded as an asset and is not amortized.

In accordance with the Intangibles – Goodwill and Other Topic of the FASB ASC, the Company performs, at a minimum, an annual valuation of its goodwill and intangible assets to test for impairment or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. For purposes of annual impairment evaluation, goodwill is assigned to the applicable reporting unit of the acquired entities giving rise to the goodwill. Fair value is determined using widely accepted valuation techniques, such as discounted cash flows and markets multiple models. These types of analyses contain uncertainties because they require management to make assumptions and to apply judgment to estimate industry economic factors and the profitability of future business strategies. It is the Company's policy to conduct impairment testing based on the Company's current business strategy in light of present industry and economic conditions, as well as the Company's future expectations. If, as a result of the assessment, the Company determines that the value of its goodwill and intangible assets are impaired, the Company will record an impairment charge in the period in which the determination is made.

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

### Foreign Currency Translation

Monetary assets and liabilities are translated into U.S. dollars at year-end exchange rates and non-monetary assets and liabilities at the exchange rates prevailing when the assets were acquired or liabilities incurred. Income and expenses are translated at the rate of exchange prevailing at the transaction date. Translation gains and losses are included in foreign exchange gains or losses unless the gain or loss is a result of trading foreign currency as part of the Company's overall investment strategy, in which case the income is recognized as other income.

### Fair value of financial instruments

Fair values of financial instruments are disclosed in the notes to the financial statements when they differ from the carrying values. Where amounts receivable and payable are subject to normal credit terms, their carrying values are used as an approximation of their fair values.

Fair value is defined as the price to sell an asset or transfer a liability (i.e. the "exit price") in an orderly transaction between market participants. Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. An asset or a liability's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation. The hierarchy is broken down into three levels as follows:

Level 1 – Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

Level 2 – Valuations based on quoted prices in active markets for similar assets or liabilities, quoted prices in markets that are not active or for which all significant inputs are observable, directly or indirectly.

Level 3 – Valuations based on inputs that are unobservable and significant to the overall fair value measurement. These are generally company generated inputs and are not market based inputs.

The Company used the following valuation technique and assumptions in estimating the fair value of financial instruments as well as the general classification of such financial instruments pursuant to the above fair value hierarchy:

At each valuation date, the Company uses a market approach technique to estimate the fair value of our fixed maturities portfolios, when possible. This market approach includes, but is not limited to, prices obtained from third party pricing services and broker-dealers for identical or comparable securities. The pricing services use market quotations for securities that have quoted prices in active markets. When quoted market prices are unavailable, the pricing services prepare estimates of fair value measurements using observable market inputs such as yield curves, credit risks and spreads, measures of volatility, expected cash flows including prepayment speeds, reported trades and broker/dealer quotes.

The fair values of the Company's interests in hedge fund investments are based upon the Net Asset Values of the underlying investment funds as reported by the investment managers, or their independent administrators. Depending on the Company's ability to redeem its hedge fund investments at the reported net asset value per share (or its equivalent) within a reasonable period of time, the hedge fund investment will be categorized within Level 2 or Level 3 of the fair value hierarchy.

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

A review of fair value hierarchy classifications is conducted on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification for certain financial assets and liabilities. Reclassifications between Level 1, 2 and 3 of the fair value hierarchy are reported as transfers in and/or out as of the beginning of the quarter in which the reclassifications occur.

### Taxation

The Company's subsidiaries that are based in the United States and the United Kingdom are subject to the tax laws of those jurisdictions and the jurisdictions in which they operate.

### New Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" ("ASU 2011-04"). ASU 2011-04 has resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term "fair value". This disclosure is effective for annual periods beginning after December 15, 2011. The Company expects no significant impact resulting from the adoption of ASU 2011-04 on its consolidated results of operations and financial condition.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income" ("ASU 2011-05"). This ASU amends the FASB ASC to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This presentation is effective for annual periods beginning after December 15, 2011. The Company expects no significant impact resulting from the adoption of ASU 2011-05 on its consolidated results of operations and financial condition.

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, "Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment" ("ASU 2011-08"). ASU 2011-08 is intended to simplify how entities test goodwill for impairment. ASU 2011-08 permits an entity to first assess qualitative factors to determine whether it is "more likely than not" that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, Intangibles-Goodwill and Other. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The Company expects no significant impact resulting from the adoption of ASU 2011-08 on its consolidated results of operations and financial condition.

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

In December 2011, the FASB issued Accounting Standards Update No. 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities" ("ASU 2011-11"). The amendments in this ASU require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This disclosure is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company expects no significant impact resulting from the adoption of ASU 2011-11 on its consolidated results of operations and financial condition.

## 3. ACQUISITIONS

The Company accounts for acquisitions using the acquisition method of accounting, which requires that the acquirer recognize and measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair values.

On October 20, 2011 the Company completed the acquisition of American Millennium Insurance Company. The purchase price of $4,911,005 was funded from available cash on hand. The following summarizes the estimated fair values of the assets acquired and the liabilities assumed at the date of the acquisition:

| | |
|---|---|
| **Assets** | |
| Cash and cash equivalents | $ 2,749,106 |
| Investments | 6,008,154 |
| Note receivable | 470,000 |
| Premium receivable | 254,333 |
| Reinsurance recoverable | 293,508 |
| Accrued investment income | 59,804 |
| Due from affiliate | 1,976,643 |
| Prepaid reinsurance | 450,000 |
| Other assets | 270,238 |
| Total Assets | 12,531,786 |
| **Liabilities** | |
| Loss and loss adjustment expenses | $ 3,837,406 |
| Unearned premium | 1,137,678 |
| Deeded reinsurance payable | 3,823,749 |
| Funds withheld | 88,654 |
| Other liabilities | 377,250 |
| Total Liabilities | 9,264,737 |
| Net assets acquired at fair value | $ 3,267,049 |

The acquisition resulted in goodwill of $1,643,956, included within the consolidated statement of operations.

## 4. MARKETABLE SECURITES

The total carrying value of held for trading securities and held to maturity securities as at December 31, 2011 was $25,788,992 (2010 - $20,632,872).

| | | 2011 Fair value | | 2010 Fair value |
|---|---|---|---|---|
| Hedge fund | $ | 2,874,590 | $ | 4,269,041 |
| Convertible notes | | - | | 1,051,685 |
| Ordinary shares | | 3,679,617 | | 2,089,251 |
| Preferred Shares | | 2,614,021 | | - |
| Treasury funds | | 209,474 | | 2,476 |
| | $ | 9,377,702 | $ | 7,412,453 |

The amortized cost, gross unrealized gains and losses and estimated fair value of held to maturity securities as of December 31, 2011 and 2010, are as follows:

| 2011 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair Value |
|---|---|---|---|---|
| Preferred shares | 10,900,992 | 261,651 | 1,137,047 | 10,025,596 |
| Floating notes | 1,814,469 | 5,492 | 331,886 | 1,488,075 |
| Corporate bonds | 4,889,648 | 107,093 | 99,151 | 4,897,589 |
| | 17,605,109 | 374,236 | 1,568,084 | 16,411,260 |

| 2010 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair Value |
|---|---|---|---|---|
| Preferred shares | 9,576,352 | 640,222 | 380,562 | 9,836,012 |
| Floating notes | 3,005,439 | 311,819 | 42,701 | 3,274,557 |
| Corporate bonds | 378,968 | 31,603 | - | 410,571 |
| | 12,960,759 | 983,644 | 423,263 | 13,521,140 |

## 4. MARKETABLE SECURITES (continued)

The following table represents the fair value hierarchy for the Company's investments measured at fair value as at December 31, 2011:

| | 2011 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Hedge Funds | - | 2,874,590 | - | 2,874,590 |
| Ordinary Shares | 3,679,617 | - | - | 3,679,617 |
| Preferred Shares | 12,639,647 | - | - | 12,639,647 |
| Floating notes | - | 1,488,075 | - | 1,488,075 |
| Corporate Bonds | - | 4,897,589 | - | 4,897,589 |
| Treasury funds | 209,474 | - | - | 209,474 |
| | 16,528,738 | 9,260,254 | - | 25,788,992 |

The following table represents the fair value hierarchy for the Company's investments measured at fair value as at December 31, 2010:

| | 2010 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Hedge Funds | - | 4,269,041 | - | 4,269,041 |
| Convertible notes | - | 1,051,685 | - | 1,051,685 |
| Ordinary Shares | 2,089,251 | - | - | 2,089,251 |
| Preferred Shares | 9,836,012 | - | - | 9,836,012 |
| Floating notes | - | 3,005,439 | - | 3,005,439 |
| Corporate Bonds | - | 378,968 | - | 378,968 |
| Treasury funds | 2,476 | - | - | 2,476 |
| | 11,927,739 | 8,705,133 | - | 20,632,872 |

The Company did not impair its investment in the held to maturity portfolio in 2011 or 2010. The Company considers impairment as other than temporary if evidence indicating that an investment's cost is recoverable within a reasonable period of time is outweighed by evidence to the contrary. The Company also considers its ability and intent to hold an investment until such recovery of the security's fair value. Recognition of impairment losses for declines in the value of securities attributable to issuer-specific events are based upon all relevant facts and circumstances for each investment. Factors considered by management include, but are not limited to, the impact of issuer-specific events, dividend flow, industry-specific events, current and expected future market and economic conditions, the nature of the investment, the severity and duration of the impairment and the volatility of the security's market price.

The amortized cost and estimated fair value amounts for preferred shares and corporate bonds held at December 31, 2011 and December 31, 2010 are shown by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

## 4. MARKETABLE SECURITES (continued)

The maturity distribution for fixed maturities held as of December 31, 2011 was:

| | Amortized cost | Estimated fair value |
|---|---|---|
| Due within one year | $ 1,164,126 | $ 1,222,252 |
| Due after one year through five years | 1,685,888 | 1,726,817 |
| Due after five years | 12,940,625 | 12,041,518 |
| | $ 15,790,639 | $ 14,990,587 |

The maturity distribution for fixed maturities held as of December 31, 2010 was:

| | Amortized cost | Estimated fair value |
|---|---|---|
| Due within one year | $ 384,970 | $ 429,178 |
| Due after one year through five years | 266,576 | 297,626 |
| Due after five years | 9,272,171 | 9,488,176 |
| | $ 9,923,717 | $ 10,214,980 |

Excluded from the above table are floating rate note securities with a fair value of $1,814,469 as of December 31, 2011 (2010 - 3,005,939). The interest rates are reset quarterly, based on a margin over the Australian 90 day bank bill benchmark rate. Most of these securities have passed early redemption dates and can be redeemed at any time by the issuer of the securities. In such cases, this would be taken as the maturity date.

## 5. GOODWILL

During the year ended December 31, 2011, the Company recorded $1,643,956 of goodwill on the determination of the final purchase price of the acquisition of American Millennium Insurance Company. The Company has determined no impairment of this goodwill exists as of December 31, 2011.

## 6. LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

The following table represents the activity in the loss and loss adjustment expenses as for the years ended December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Loss and loss adjustment expense reserves, beginning of year | 6,530,573 | 3,030,094 |
| Loss and loss expenses incurred related to losses occurring in: | | |
| Current year | 2,799,047 | 82,864 |
| Prior year | 5,105,777 | 751,107 |
| Total loss and loss expenses | 7,904,824 | 833,972 |
| Losses and loss expenses paid related to losses occurring in: | | |
| Current year | 835,400 | 36,945 |
| Prior year | 2,502,168 | 644,463 |
| Total loss and loss expenses paid | 3,337,568 | 681,408 |
| **Loss and loss adjustment expense reserves** | **$ 11,097,829** | **$ 3,182,658** |

Management believes that the assumptions used establishing its provision for loss and loss adjustment expenses represent a realistic and appropriate basis for estimating those reserves as of December 31, 2011and 2010. However, these assumptions are subject to change and the Company continually reviews and adjusts its reserve estimates taking into account all currently known information and updated assumptions related to unknown information. While management believes it has made a reasonable estimate of loss expenses occurring up to the balance sheet date, the ultimate costs of claims incurred could exceed the Company's reserves and have a materially adverse effect on its future results of operations and financial condition.

## 7. DEPOSIT ASSETS

Deposit assets represent cash, fixed deposits, accrued interest and marketable securities held to meet the Company's future obligations on non risk transfer business.

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Carrying value | Fair value | Carrying value | Fair value |
| Cash | $ 910,128 | $ 910,128 | $ 1,484,862 | $ 1,484,862 |
| Accrued interest | 300,247 | 300,247 | 306,999 | 306,999 |
| Marketable securities | 8,878,543 | 8,878,543 | 8,851,839 | 8,851,839 |
| Fixed deposits | 40,590,316 | 41,519,218 | 38,328,160 | 40,660,516 |
| | $ 50,679,234 | $ 51,608,136 | $ 48,971,860 | $ 51,304,216 |

## 7. DEPOSIT ASSETS (continued)

The total deposit asset balance of $50,679,234 (2010 - $48,971,860) comprises amounts due within one year (current) and amounts due after one year through 5 years (deferred) as follows:

| | 2011 | 2010 |
|---|---|---|
| Current balances | $ 46,129,746 | $ 38,725,164 |
| Deferred balances | 4,549,488 | 10,246,696 |
| | $ 50,679,234 | $ 48,971,860 |

The estimated fair value at December 31, 2011 of $51,608,136 (2010 - $51,304,216) represents management's best estimate using all available information to the report date.

## 8. DEPOSIT LIABILITIES

Deposit liabilities represent loss reserves due to insureds and LOC fees due to banks on the Company's non risk transfer business. The total balance of $50,679,234 (2010 - $48,971,860) comprises amounts due in less than one year (current) and amounts due after one year through 5 years (deferred) as follows:

| | 2011 | 2010 |
|---|---|---|
| Current balances | $ 46,074,937 | $ 38,700,151 |
| Deferred balances | 4,604,297 | 10,271,709 |
| | $ 50,679,234 | $ 48,971,860 |

Included in the deposit liability above are amounts aggregating $41,610,918 (2010 - $39,794,585) which are effectively recorded at their estimated net present value using discount rates ranging between 0.70% and 5.68% (2010 - 0.70% and 5.68%) which reflect the anticipated payout patterns of the losses at their ultimate expected value.

The Company's exposure under these contracts is limited to the value of the Deposit assets at any point in time.

## 9. SHARE CAPITAL

Capital stock is comprised of the following authorized, issued and fully paid shares of the par value $1 each:

| | 2011 | 2010 |
|---|---|---|
| Common shares (20,000,000 shares in 2011 and 2010) | $ 20,000,000 | $ 20,000,000 |

No dividends were declared or paid during 2011 (2010 - $Nil).

## 10. RELATED PARTY TRANSACTIONS

Included in accounts payable are advances made by affiliated companies totaling $135,099 (2010 - $142,831).

Included in accounts receivable and accrued interest are advances made to the parent company and affiliates totaling $769,744 (2010 - $870,744). The advances are non-interest bearing and repayable on demand.

## 11. LETTERS OF CREDIT

The Company has pledged cash and cash equivalents of $515,099 (2010 - $2,890,031) and deposits of $40,954,816 (2010 - $39,024,569) to banks as security for letters of credit totalling $41,918,305 (2010 - $40,620,863) in respect of the Company's obligations under reinsurance programs and the Company's guarantee for a letter of credit of $364,500 (2010 - $604,500) for the benefit of members of the PMA Insurance Group.

## 12. CONTINGENCIES AND COMMITTMENTS

The Company is liable on reinsurance ceded to the extent that the companies to which the business is ceded do not meet their contractual obligations. In the opinion of management, no loss to the Company is expected to arise in the future as a result of reinsurance ceded. Recoveries are only due on discontinued business.

The investment portfolio is managed following prudent standards of diversification across counterparties, issuers, asset classes and geographical regions. Investment guidelines are designed to limit the holdings of a single issue and issuer, control non-US dollar currency exposure and minimize sovereign risk. At December 31, 2011, 85 % (2010 – 85%) of the fixed and floating income portfolio at carrying value was rated investment grade.

The Company's investment guidelines permit short selling, where by the Company sells borrowed securities which must, at some date, be repurchased and returned to the lender. The risk associated with this practice is that, if the market value of the securities sold short increases, the Company may realize losses upon repurchase at prices which may exceed that liability presented in the consolidated balance sheet. Further, in unusual circumstances, the Company may be unable to repurchase securities to close the short position, except at prices above those previously quoted in the market. There were no short positions open at year end, and all short positions have been covered.

## 13. TAXATION

The Company is incorporated in Bermuda, and under current Bermuda law, is not required to pay any taxes in Bermuda on either income or capital gains. The Company has received an undertaking from the Minister of Finance in Bermuda that in the event of such taxes being imposed the Company will be exempted from taxation until the year 2035. The Company is subject to withholding tax on investment income from foreign securities.

The Company's subsidiaries that are based in the United States and the United Kingdom are subject to the tax laws of those jurisdictions and the jurisdictions in which they operate.

At December 31, 2011, the Company had recorded a tax recovery of $103,030 (2010 – expense of $146,409).

The Company has not recorded any interest or penalties during the years ended December 31, 2011 and 2010.

## 14. STATUTORY REQUIREMENTS

Under the Bermuda Insurance Act 1978 ("The Act"), the Company is required to prepare Statutory Financial Statements and to file a Statutory Financial Return. The Act also requires the Company to meet certain minimum capital and surplus requirements. To satisfy these requirements, the Company was required to maintain a minimum level of statutory capital and surplus of $1,271,014 at December 31, 2011 (2010 - $1,000,000). The Company's statutory capital and surplus was $18,691,727 at December 31, 2011 (2010 - $21,947,021).

The Company is also required to maintain a minimum liquidity ratio whereby the value of its relevant assets is not less than 75% of the amounts of its relevant liabilities. At December 31, 2011 the Company is required to maintain relevant assets of at least $46,708,895. At that date relevant assets are $71,032,726 and the minimum liquidity ratio is therefore met.

## 15. SUBSEQUENT EVENTS

Subsequent events have been evaluated through July 2, 2012, which is the date the financial statements were available to be issued.