

The Philadelphia
Contributionship

266th Annual Report

2018

WELL DONE IS BETTER THAN
WELL SAID



THE PHILADELPHIA CONTRIBUTIONSHIP MUTUAL HOLDING COMPANY

TPC HOLDINGS, INC.

VECTOR SECURITY HOLDINGS, INC.

THE PHILADELPHIA CONTRIBUTIONSHIP FOR THE
INSURANCE OF HOUSES FROM LOSS BY FIRE, INC.

THE PHILADELPHIA CONTRIBUTIONSHIP INSURANCE COMPANY

GERMANTOWN INSURANCE COMPANY

FIRST INSURANCE COMPANY OF AMERICA

FRANKLIN AGENCY, INC.

At A Glance

The Philadelphia Contributionship Mutual Holding Company is a mutual holding company serving as the ultimate controlling parent in the corporate structure. The principal business of The Philadelphia Contributionship Mutual Holding Company is to hold the stock of TPC Holdings, Inc.

TPC Holdings, Inc. is a stock holding company whose principal business is to hold the stock of The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire, Inc. and Vector Security Holdings, Inc.

The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire, Inc. is the oldest successful property and casualty insurance company in the United States, having been founded in 1752. The company was converted from a mutual company to a stock company in 2009.

The Philadelphia Contributionship is our group of insurance companies writing residential business in urban and suburban communities. Our Company was founded by Benjamin Franklin and his fellow fire-fighters to provide insurance to urban Philadelphia homeowners. We provide homeowners, fire and liability insurance to customers in New Jersey, Pennsylvania, Delaware, Maryland and Virginia. We have earned the distinction of A rating or higher from A.M. Best Company for over 90 years.

Vector Security Holdings, Inc., our residential and commercial security subsidiary, is one of the top ten security providers in North America. Vector provides electronic security services to commercial and residential markets including fire and burglary detection, video, access control, environmental monitoring, home automation and commercial analytics. The Vector Security Networks Division operates exclusively in the commercial space offering electronic security services, as well as, customized managed network services including broadband and broadband-enabled services, SD-WAN, network deployment, network management and mobile applications.

Our Vision

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To be the most reliable partner for people seeking to
protect their homes and their futures.

OUR MISSION

WE PROVIDE INSURANCE PROTECTION THAT PUTS
PEOPLE FIRST, THROUGH UNIQUELY PERSONAL SERVICE,
STRONG PARTNERSHIPS AND AN UNMATCHED HISTORY
OF FINANCIAL STABILITY.





LETTER TO POLICY HOLDERS

“Well done is better than well said” is one of many words of wisdom attributed to the most famous of our founders, Benjamin Franklin. In our businesses, both insurance and security, delivering on the promises we make to our customers is critical to our value proposition, reputation and ultimately, our long term success.

The Philadelphia Contributionship has delivered on its promises for 267 years. In 2018, our employees provided outstanding service to our customers under very challenging conditions. Based on the vast majority of feedback we received from our customers, we can confidently say to our staff: “Well done.” High quality service, backed by the financial strength that underscores our dependability and longevity, is a recipe for success that has served us well historically, and will continue to drive success well into the future.

INSURANCE GROUP OPERATIONS

2018 was a difficult year for the insurance operations. Our operating territory experienced severe weather conditions that included sub-freezing temperatures early in the year, followed by record, or near record, precipitation. There were thirteen weather catastrophes during the year that generated 3,300 claims and nearly \$23 million in losses - triple the expected amount. Needless to say, our resources were stretched under those conditions, but due to the perseverance of our claims staff, we were able to service our customers well in their time of need.

We have been successful in executing on our strategy to diversify our business over a broader geography and have achieved a more balanced distribution of exposure across our five-state footprint. We ended 2018 with 36% of our policies in areas we targeted for expansion.

Direct written premium was \$158.0 million in 2018, up 8.8% from 2017. Net premiums earned grew 7.2% in 2018 to \$133.9 million. Gross investment income for the year was \$11.6 million, up 6.6% from 2017. Net realized gains on investments were \$8.0 million bringing total revenue from insurance operations for the year to \$153.4 million, up 2.2% from 2017.

Losses and loss adjustment expenses, at \$110.8 million, were up significantly in 2018 due primarily to higher losses from weather related catastrophes. Underwriting and investment expenses were modestly higher in 2018 consistent with our growth in policy counts, partially offset by lower investment expenses. In total, losses and expenses were \$154.2 million for the year.

Overall, after paying \$0.9 million of dividends to our members, the insurance operation produced a loss before income taxes of \$1.5 million in 2018.

In 2018 the company was, once again, named to Philly.com’s list of Top Workplaces. This distinction is based on feedback provided directly by our staff and so, affirms that The Philadelphia Contributionship remains an employer of choice.

Finally, early in 2018, The Philadelphia Contributionship's financial strength rating from AM Best Company was affirmed as A (Excellent) in recognition of our outstanding financial position.

SECURITY GROUP OPERATIONS

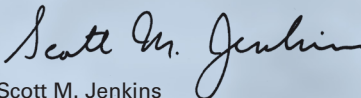
Vector Security, Inc. produced earnings before interest, taxes, depreciation and amortization of \$51.4 million, 4.1% above 2017. Total revenues for the year increased 2.1% to \$302.4 million. By creating internal efficiencies, we were able to increase gross profit margin from 41.0% to 41.5%. Vector opened two retail storefronts in prominent locations in 2018, in order to offer a customer experience center and increase brand awareness. As part of the brand awareness initiative, this year we sponsored three National Hockey League teams. This initiative allows us to gain visibility through a number of means, including: on-ice and dasher board signage, in-arena advertising, sponsorship of security gates, social media and on-air coverage.

Our branch operations continue to meet the residential demand for security and home automation, including an integrated platform for security, locks, doorbells, garage door controls, thermostats, cameras and lighting. We also offer intrusion protection, fire monitoring, access control and video monitoring to the commercial market within our branch footprint. Vector Security Networks, our national account brand, has expanded beyond their initial retail focus, to also include the quick-serve restaurant and healthcare industries. Services provided to these markets include network services, intrusion protection, fire monitoring, access control, video monitoring, environmental and shooter detection. Keeping pace with rapidly changing technology, Vector continues to introduce and support reliable products and services that provide value to our customers.

CONSOLIDATED BALANCE SHEETS

Total assets as of December 31, 2018 are \$755.3 million, down 6.2% from 2017. Total liabilities declined 3.4% to \$410.6 million. Total equity as of December 31, 2018 is \$344.7 million, down 9.2% from 2017. The strength of The Philadelphia Contributionship's financial condition is intact and the company is well-positioned to meet our commitments for the long run.

Our Directors, officers and employees recognize that our customers have choices when selecting an insurer and security provider. Thank you for choosing The Philadelphia Contributionship. We work hard to earn your trust and confidence and are committed to providing the level of service that has allowed us to prosper since 1752.



Scott M. Jenkins
Chairman of the Board

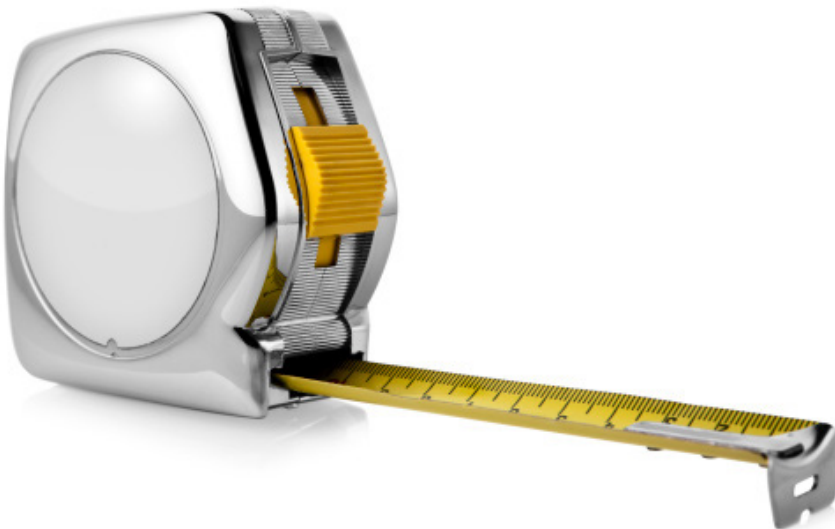


Robert G. Whitlock, Jr., FCAS, MAAA
President and Chief Executive Officer

CONSOLIDATED FINANCIAL STATEMENTS

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CONSOLIDATED BALANCE SHEETS
 DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

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ASSETS	2018	2017
INSURANCE GROUP ASSETS		
Investments:		
Fixed income securities	\$ 154,022	\$ 156,944
Convertible bonds	15,142	15,816
Preferred stocks	634	771
Convertible preferred stocks	1,425	1,701
Common stocks	231,338	267,679
Other invested assets	36,448	37,675
	<u>439,009</u>	<u>480,586</u>
Cash and cash equivalents	20,732	11,071
Reinsurance recoverable and receivable	14,240	13,725
Prepaid reinsurance premiums	2,793	2,388
Premiums receivable	9,887	9,698
Accrued income from investments	1,453	1,704
Income tax recoverable	2,738	1,342
Deferred acquisition costs	16,838	15,821
Property and equipment, net	3,393	4,497
Other assets	626	595
	<u>511,709</u>	<u>541,427</u>
SECURITY GROUP ASSETS		
Current assets:		
Cash and cash equivalents	613	833
Trade accounts receivable, less allowance for doubtful accounts of \$1,403 in 2018 and \$1,666 in 2017	22,886	21,642
Unbilled revenue	12,737	10,364
Inventories	4,618	4,959
Prepaid expenses and other current assets	7,418	7,292
Income taxes receivable	117	623
	<u>48,389</u>	<u>45,713</u>
Property and equipment, net	31,473	29,998
Intangible assets, net	112,626	134,512
Goodwill, net	21,154	25,796
Deferred income taxes	18,095	17,340
Other noncurrent assets	842	1,178
Deferred charges	10,034	8,377
Interest rate swap receivable	947	467
	<u>243,560</u>	<u>263,381</u>
Total Security Group assets	<u>243,560</u>	<u>263,381</u>
Total assets	<u>\$ 755,269</u>	<u>\$ 804,808</u>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

LIABILITIES AND EQUITY	2018	2017
INSURANCE GROUP LIABILITIES		
Unpaid losses and loss adjustment expenses	\$ 96,558	\$ 90,452
Unearned premiums	83,872	77,213
Advance premiums	2,906	2,077
Deposit premiums	15,431	15,450
Deferred income taxes	12,351	21,940
Ceded premium payable	771	549
Other liabilities	11,203	11,638
Total Insurance Group liabilities	223,092	219,319
SECURITY GROUP LIABILITIES		
Current liabilities:		
Current maturities of long-term debt	1,489	1,750
Accounts payable and accrued expenses	37,819	32,640
Customer deposits	760	586
Unearned revenue	12,018	11,907
Purchase holdbacks	1,114	3,374
Total current liabilities	53,200	50,257
Long-term debt, less current maturities	123,521	146,327
Unearned revenue	6,027	5,259
Other long-term liabilities	4,757	4,068
Total Security Group liabilities	187,505	205,911
Total liabilities	410,597	425,230
EQUITY		
Unassigned equity	291,132	293,169
Accumulated other comprehensive income	53,540	86,409
Total equity	344,672	379,578
Total liabilities and equity	\$ 755,269	\$ 804,808

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

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	2018	2017
INSURANCE GROUP		
Revenue:		
Net premiums earned	\$ 133,881	\$ 124,900
Gross investment income	11,592	10,878
Net realized gains on investments	7,957	14,374
Total revenue	153,430	150,152
Losses and expenses:		
Losses and loss adjustment expenses	110,783	80,738
Underwriting expenses	40,806	39,017
Investment expenses	2,645	2,939
Total losses and expenses	154,234	122,694
(Loss) income before other income, dividends to policyholders, and income tax expense	(804)	27,458
Other income, net	202	341
Dividends to policyholders	(884)	(959)
Insurance Group (loss) income before income tax (benefit) expense	(1,486)	26,840
SECURITY GROUP		
Revenue	302,430	296,262
Cost of sales	177,035	174,809
Gross profit	125,395	121,453
Operating expenses:		
Selling, general, and administrative	74,051	72,088
Acquisition-related costs	—	113
Depreciation	11,491	11,344
Amortization and impairment of intangible assets and goodwill	35,928	35,890
Total operating expenses	121,470	119,435
Operating income	3,925	2,018
Other:		
Interest expense	(6,051)	(5,669)
Other income, net	21	90
Security Group loss before income tax (benefit) expense	(2,105)	(3,561)
(Loss) income before income tax (benefit) expense	(3,591)	23,279
Income tax (benefit) expense	(1,554)	372
Net (loss) income	\$ (2,037)	\$ 22,907

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
YEARS ENDED DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

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	2018	2017
Net (loss) income	<u>\$ (2,037)</u>	<u>\$ 22,907</u>
Other comprehensive (loss) income, net of tax:		
Unrealized (losses) gains on securities available-for-sale:		
Unrealized net holding gains arising during the year (net of tax of \$(6,762) in 2018 and \$15,199 in 2017)	(25,437)	28,226
Less: reclassification adjustment for net realized gains included in net income (net of tax of \$2,112 in 2018 and \$4,853 in 2017)	<u>7,944</u>	<u>9,013</u>
	<u>(33,381)</u>	<u>19,213</u>
Cash flow hedge:		
Change in fair value of cash flow hedge (net of tax of \$143 in 2018 and \$204 in 2017)	539	768
Less: reclassification adjustment for settlement of cash flow hedge included in net income (net of tax of \$43 in 2018 and \$106 in 2017)	<u>160</u>	<u>399</u>
	<u>379</u>	<u>369</u>
Defined benefit pension plan:		
Change in actuarial assumptions	382	(201)
(Loss) asset gain and amortization of net loss	(190)	460
Experience (loss) gain	<u>(59)</u>	<u>4</u>
Defined benefit pension plan, net actuarial gain arising during the year (net of tax of \$35 in 2018 and \$141 in 2017)	<u>133</u>	<u>263</u>
Other comprehensive (loss) income	<u>(32,869)</u>	<u>19,845</u>
Comprehensive (loss) income	<u>\$ (34,906)</u>	<u>\$ 42,752</u>

CONSOLIDATED STATEMENTS OF EQUITY
YEARS ENDED DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

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	Unassigned Equity	Accumulated Other Comprehensive Income	Total
BALANCE, JANUARY 1, 2017	\$ 285,830	\$ 50,996	\$ 336,826
Net income	22,907	—	22,907
Reclassification of the stranded tax effects as a result of the Tax Reform Act	(15,568)	15,568	—
Other comprehensive income, net of tax	—	19,845	19,845
BALANCE, DECEMBER 31, 2017	293,169	86,409	379,578
Net loss	(2,037)	—	(2,037)
Other comprehensive loss, net of tax	—	(32,869)	(32,869)
BALANCE, DECEMBER 31, 2018	\$ 291,132	\$ 53,540	\$ 344,672

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

	2018	2017
CASH FLOW FROM OPERATING ACTIVITIES		
Net (loss) income	\$ (2,037)	\$ 22,907
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains on investments	(7,957)	(14,374)
Depreciation and amortization	49,977	49,902
Deferred income taxes	(1,606)	(6,950)
Gains on disposals of property and equipment	(155)	(231)
Change in assets and liabilities, net of effects of acquisitions:		
Reinsurance recoverable and receivable	(515)	(743)
Prepaid reinsurance premiums	(405)	(508)
Premiums receivable	(189)	(603)
Accrued income from investments	251	(129)
Deferred acquisition costs	(1,017)	(929)
Unpaid losses and loss adjustment expenses	6,106	(1,075)
Unearned premiums	6,659	4,510
Advance premiums	829	(115)
Deposit premiums	(19)	(152)
Other liabilities	(46)	3,289
Income taxes and other receivables	(890)	(314)
Prepaid expenses and other assets	(116)	(496)
Trade accounts receivable, unbilled revenue, and inventories	(3,276)	694
Accounts payable, accrued expenses and purchase holdbacks	5,868	3,058
Unearned revenue and customer deposits	1,053	2,171
Deferred charges	(1,657)	(2,054)
Net cash provided by operating activities	\$ 50,858	\$ 57,858

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CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
YEARS ENDED DECEMBER 31, 2018 AND 2017

(IN THOUSANDS, UNLESS OTHERWISE NOTED)

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	2018	2017
CASH FLOW FROM INVESTING ACTIVITIES		
Cash paid for acquisitions, net of cash received	\$ (11,660)	\$ (23,746)
Purchases of property, plant and equipment	(12,304)	(12,371)
Proceeds from disposals of property and equipment	156	258
Purchases of fixed income securities	(90,034)	(71,179)
Purchases of convertible bonds	(14,822)	(12,178)
Purchases of common stocks	(100,937)	(96,692)
Purchases of convertible preferred stocks	(122)	(263)
Purchases of other invested assets	(5,376)	(130)
Proceeds from sales of fixed income securities	71,820	47,465
Proceeds from sales of convertible bonds	14,526	9,217
Proceeds from maturities/calls of fixed income securities	16,559	11,395
Proceeds from the sales of common stocks	114,610	96,858
Proceeds from the sales of convertible preferred stocks	211	3,161
Proceeds from the sales of other invested assets	—	31
Net cash used in investing activities	(17,373)	(48,174)
CASH FLOW FROM FINANCING ACTIVITIES		
Proceeds from revolving credit agreements	111,341	75,460
Payments on revolving credit agreements	(133,658)	(85,616)
Principal payments on capital leases	(1,727)	(1,893)
Net cash used in financing activities	(24,044)	(12,049)
Net increase (decrease) in cash and cash equivalents	9,441	(2,365)
CASH AND CASH EQUIVALENTS, BEGINNING	11,904	14,269
CASH AND CASH EQUIVALENTS, ENDING	\$ 21,345	\$ 11,904
SUPPLEMENTARY CASH FLOWS INFORMATION		
Interest paid	\$ 5,659	\$ 5,237
Income taxes paid	\$ 3,113	\$ 9,550
SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
In conjunction with acquisitions, the Security Group:		
Recorded purchase holdbacks	\$ 940	\$ 3,111
Capital leases	\$ 977	\$ 1,377

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of The Philadelphia Contributionship Mutual Holding Company (the Company), a mutual holding company, and its wholly-owned subsidiaries: TPC Holdings, Inc., The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire, Inc. (The Contributionship), and Vector Security Holdings, Inc. (Vector).

The consolidated financial statements include the accounts of The Contributionship, a stock company, and its wholly-owned subsidiaries, The Philadelphia Contributionship Insurance Company, Germantown Insurance Company, First Insurance Company of America, and Franklin Agency, Inc. (collectively, the Insurance Group), and Vector. Vector is the parent company of the following wholly-owned subsidiaries: Vector Security, Inc., Vector International Holdings, Inc., Vector Security Canada, Inc., and Vector Security de Mexico, S.A. de C.V., and Vector Intelligent Solutions, LLC (VIS) (collectively, the Security Group). The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), which differ in some regard from those followed in reports to insurance regulatory authorities. All significant intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

The Insurance Group writes property and casualty insurance for homeowners and multi-family dwellings principally in urban communities in Pennsylvania, New Jersey, Delaware, Maryland, and Virginia. The Insurance Group had approximately 160,000 policyholders at December 31, 2018.

Vector sells, installs, services, and manages intelligent security and home automation products and solutions and provides security monitoring services as well as network services through advanced electronic systems designed to detect intrusion, as well as fire, water, temperature, and medical emergencies. Vector also does business with large national commercial accounts to which it provides equipment and installation, monitoring, and managed network services. Vector's customers are located throughout North America. Vector has approximately 277,000 residential and commercial customers as of December 31, 2018. No such customer accounted for more than 10% of the December 31, 2018 and 2017 trade accounts receivable balance or revenue for the years then ended.

Premiums

The Contributionship issues perpetual fire and homeowners insurance policies. When a perpetual policy is issued, a deposit premium is received, which is reflected as a liability. The deposit premium is returned if coverage terminates.

The Insurance Group also issues term policies for property and casualty coverage. Premiums on such policies are reflected in income over the effective period of the policies. Unearned premiums are computed on either a monthly pro rata basis or a daily basis over the term of the policy.

Reinsurance

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

The Contributionship cedes reinsurance to other insurance companies to minimize the net loss potential arising from large losses and as well as from an aggregation of losses. An allowance is established for amounts deemed uncollectible and losses are charged against the allowance when the uncollectibility of amounts recoverable from reinsurers is confirmed. There was no such allowance recorded as of December 31, 2018, or 2017, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2018 AND 2017

(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

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Acquisition Costs

Acquisition costs, such as commissions, premium taxes, and certain other underwriting and agency expenses that vary with and are directly related to the successful acquisition of new and renewal business, are deferred and amortized over the effective period of the related insurance policies. The Insurance Group determines whether acquisition costs are recoverable considering future losses and loss adjustment expenses, policy maintenance costs and anticipated investment income. To the extent that acquisition costs are determined not to be recoverable, the difference is charged to income in the period identified. All deferred acquisition costs at December 31, 2018 and 2017 were determined to be recoverable.

Liability for Unpaid Losses and Loss Adjustment Expenses

The reserving process for the unpaid loss and loss adjustment expenses ("LAE") provides for the Insurance Group's best estimate at a particular point in time of the ultimate unpaid cost of all losses and loss adjustment expenses incurred, including settlement and administration of claims, and is based on facts and circumstances known and includes losses that have been incurred but not yet reported. The process includes using actuarial methodologies to assist in establishing these estimates, judgments relative to estimates of future claims severity and frequency, the length of time before claims will develop to their ultimate level and the possible changes in the law and other external factors that are often beyond the Insurance Group's control. The methods used to select the estimated claim reserves include the loss ratio method, loss development methods, the Bornhuetter-Ferguson (B-F) method, and the Berquist-Sherman (B-S) method. The process produces carried reserves set by management's best estimate and is the result of numerous best estimates made by line of business, accident year, and broken out between losses and loss adjustment expenses. The amount of loss and loss adjustment expense reserves for reported claims is based primarily upon a case-by-case evaluation of coverage, liability, injury severity, and any other information considered pertinent to estimating the exposure presented by the loss. The amounts of loss and loss adjustment expense reserves for unreported claims are determined using historical information by line of insurance as adjusted to current conditions.

Due to the inherent uncertainty associated with the reserving process, the ultimate liability may differ, perhaps substantially, from the original estimate. Such estimates are regularly reviewed and updated and any resulting adjustments are included in the current year's results. These liabilities are closely monitored and are recomputed periodically using the most recent information on reported claims and a variety of statistical techniques. Specifically, on at least a quarterly basis, the Insurance Group reviews, by line of business, existing revenues, new claims, changes to existing case reserves and paid claims with respect to the current and prior years.

Fixed Income Securities and Preferred & Common stocks

All fixed income securities, preferred and common stocks are classified as available-for-sale and are carried at fair value. Management reviews the securities in its investment portfolio on a periodic basis to specifically identify individual securities that have incurred an other-than-temporary decline in fair value below cost or amortized cost. As part of its periodic review process, management utilizes information received from its outside professional asset manager to assess each issuer's current credit situation. When management's review identifies an other-than-temporary impairment in the valuation of a fixed income security, it compares its projected discounted cash flows to the amortized cost in order to determine the credit related portion and the non-credit related portion of the loss. The credit related portion is recorded as a charge in the consolidated statement of operations while the non-credit related portion is recorded through other comprehensive (loss) income and included as a component of accumulated other comprehensive income in the consolidated balance sheet. For preferred and common stocks, the cost of the security is adjusted and recognized as a realized loss in the statement of operations.

For structured securities, management projects cash flows using loss adjusted cash flows that contemplate current market factors such as prepayment assumptions, expected default assumptions, and the current condition of the guarantor of the security. For structured

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2018 AND 2017

(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

securities, the discount rate used in the present value calculation is the security's current effective interest rate. The discount rate used for other fixed income securities is the security's effective interest rate at the date of acquisition.

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In addition to issuer-specific financial information, general economic data and management's projections of discounted cash flows, management also assesses whether it has the intent to sell a particular security or whether it is more-likely-than-not it will be required to sell the security before its anticipated recovery. When management determines that it either intends to sell or is no longer more likely than not to hold the security until its anticipated recovery, a realized loss is recorded in the consolidated statement of operations for the full amount of the difference between fair value and amortized cost.

Dividends and interest income are recognized when earned. Premiums and discounts on fixed income securities are amortized or accreted based upon the effective-interest method. Realized gains and losses on investments are determined by the specific identification method.

Other Invested Assets

Other invested assets consist of investments in limited partnerships that invest in oil and gas interests, commercial and residential real estate and equity and debt securities of public and privately held companies. These investments are classified as available-for-sale investments and are carried at fair value. Net unrealized gains (losses) are reported as a component of accumulated other comprehensive income. See Note 3 for more information on the determination of fair value.

The Company reviews other invested assets in its investment portfolio on a periodic basis to specifically identify individual securities that have incurred an other-than-temporary decline in fair value below cost. This review encompasses, among other things, recent issuer activities, such as defaults, quarterly earnings announcements, and other pertinent financial news for the issuer, recent developments and economic outlooks for particular industries, rating agency actions, and the length of time and extent to which fair value has been less than cost. When management's review identifies an other-than-temporary impairment in the valuation of a security, a realized loss is recognized in the consolidated statement of operations.

Convertible Bonds and Preferred Stocks

The Company's investments in convertible bonds and convertible preferred stocks are considered hybrid financial instruments and are carried at estimated fair value, with changes in estimated fair value reported in net realized gains on investments in the consolidated statements of operations and comprehensive income.

Property and Equipment - Insurance Group

Property and equipment, which primarily consist of the Insurance Group's home office, electronic data processing equipment, furniture and fixtures, a software license and related implementation costs, are stated at cost, less accumulated depreciation of \$14,463 and \$13,045 at December 31, 2018 and 2017, respectively. Depreciation is provided using the straight-line method over the estimated useful lives of depreciable assets. Land is not subject to depreciation.

Property and Equipment - Security Group

Property and equipment are stated at cost less accumulated depreciation. Equipment under capital leases is stated at the present value of minimum lease payments. Vector provides for depreciation over the estimated useful lives of the related assets utilizing the straight-line method. Estimated useful lives range from 3 to 12 years, with the exception of buildings, which are depreciated over approximately 25 years.

Vector installs certain home security package systems in residences if the customer commits to a monitoring arrangement for a minimum period of time. These security systems remain the property of Vector. The costs of the security systems, including costs of installation, are capitalized and depreciated over their estimated useful life of 7 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2018 AND 2017

(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

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Balances consist of the following as of December 31:

	2018	2017
Land	\$ 200	\$ 200
Buildings and improvements	4,508	4,328
Home security package systems	49,730	45,111
Furniture and fixtures	4,511	4,294
Vehicles and equipment	21,255	20,848
Construction-in-progress	126	317
	<u>80,330</u>	<u>75,098</u>
Less accumulated depreciation	(48,857)	(45,100)
Total Property and Equipment	<u>\$ 31,473</u>	<u>\$ 29,998</u>

Revenue Recognition

Vector's major sources of revenue are equipment sales, installation, monitoring and managed network services as described above. While Vector frequently sells these elements in a bundled arrangement, it also sells each element individually, with no discounts given for the elements included in a bundled arrangement. Accordingly, when elements are included in a bundled arrangement, each element is treated as a separate unit of accounting. The revenue recognition policy with respect to each of the three major elements is as follows:

- Installation and equipment revenue - Recognized as services are performed on a percentage-of-completion basis calculated on a cost-to-cost comparison.
- Service revenue - Recognized as services are performed for time and material agreements and recognized ratably over the service period for those agreements entered into under a fixed fee arrangement.
- Monitoring and managed network revenue - Recognized ratably over the service period with amounts billed in advance of service delivery deferred and amortized over the applicable period of service.

In accordance with Accounting Standards Update (ASU) 2009-13, *Revenue Recognition (Topic 605): Multiple Deliverable Revenue Arrangements* (EITF Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables*), the overall arrangement fee for bundled arrangements is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by vendor specific objective evidence or third party evidence or are based on the entity's estimated selling price. Application of the "residual method" of allocating an overall arrangement fee between delivered and undelivered elements is not permitted.

As part of Vector's residential business, they offer certain packages, whereby they bundle a free or low cost equipment package with a long term monitoring contract, which is generally three to five years. Vector retains ownership of the system for the duration of the monitoring contract. The equipment costs, including related direct costs, are capitalized and included in home security package systems on the consolidated balance sheet and amortized to cost of sales over the expected life of the customer relationship, which is generally seven years. Selling costs are recorded as deferred charges on the consolidated balance sheet and amortized to selling, general and administrative expense. Upfront fees charged in connection with these packages are recorded as unearned revenue on the consolidated balance sheet. These packages are priced so that the additional monitoring and other fees generated over the life of the contract will exceed the cost of the equipment and related direct costs.

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Inventories

Inventories, consisting primarily of security and home automation products, are stated at the lower of average cost and net realizable value.

Intangible Assets

In accordance with ASC Topic 350, *Intangibles – Goodwill and Other*, as of January 1, 2013, goodwill is amortized over 10 years and tested when a triggering event occurs. A triggering event draws into question whether the fair value of the entity may be below its carrying amount.

In accordance with Impairment or Disposal of Long Lived Assets subsections of ASC Subtopic 360-10, *Property, Plant, and Equipment – Overall*, long lived assets, such as property, plant, and equipment, and purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long lived asset or asset group be tested for possible impairment, Vector first compares the undiscounted future cash flows of that asset or asset group to its carrying value. If the carrying value of the long lived asset or asset group is greater than the undiscounted future cash flows, an impairment is recognized to the extent that the carrying value exceeds its estimated fair value. Vector recorded impairment expense, through amortization expense, on their customer service agreements of \$1,999 and \$1,290 during 2018 and 2017, respectively.

Newly acquired customer service agreements, that have been purchased through Vector's authorized dealer program are being amortized on a straight-line basis over a seven year period, which reflects the historical attrition rate on Vector's customer service agreements acquired through the authorized dealer program.

Customer relationships, which were recorded in connection with acquisitions, are amortized on a straight-line basis over a period of 13 years.

Covenants not-to-compete are generally amortized on a straight-line basis over periods ranging from 3 to 5 years, depending upon the length of the agreement. All intangible assets have been recorded in connection with acquisitions.

Covenants not to solicit, which were recorded in connection with acquisitions, are amortized on a straight-line basis over a period of 8 years.

Trade names, which were recorded in connection with acquisitions, are amortized on a straight-line basis over a period of 5 years.

Technology, which was recorded in connection with acquisitions, is amortized on a straight-line basis over a period of 5 years.

All fully amortized intangible assets are removed from Vector's asset system in the year following full amortization.

Income Taxes

Deferred income taxes are recognized in the consolidated financial statements for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases. Deferred income tax expense is the result of changes in deferred tax assets and liabilities. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred income tax asset will not be realized.

A tax position is recognized as a benefit at the largest amount that is more likely than not to be sustained in a tax examination solely on its merits. An uncertain tax position will not be recognized if it has a less than 50% likelihood of being sustained. The Company recognizes interest and penalties accrued related to uncertain tax positions as a component of income tax expense. The Company has no such uncertain tax positions as of December 31, 2018 or 2017.

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Cash Equivalents

Cash equivalents consist of highly liquid short-term investments with an expected maturity at date of purchase of three months or less.

Credit Risk

The Company maintains cash balances in major financial institutions in excess of the federally insured limit of \$250 by the Federal Deposit Insurance Corporation (FDIC). The Company has not experienced any losses and believes it is not exposed to any significant credit risk on cash and cash equivalents.

Derivative Instruments and Hedging Activities

Vector accounts for derivatives and hedging activities in accordance with ASC Topic 815, *Derivatives and Hedging*, which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet at their respective fair values.

Vector only enters into derivative contracts that it intends to designate as a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). For all hedging relationships, Vector formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the hedged item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed prospectively and retrospectively, and a description of the method of measuring ineffectiveness. Vector also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting cash flows of hedged items. For derivative instruments that are designated and qualify as a cash-flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

Vector discontinues hedge accounting prospectively when it determines that the derivative is no longer effective in offsetting cash flows of the hedged item, the derivative expires or is sold, terminated, or exercised, the derivative is designated as a hedging instrument because it is unlikely that a forecasted transaction will occur, or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

In all situations in which hedge accounting is discontinued and the derivative is retained, Vector continues to carry the derivative at its fair value on the balance sheet and recognizes any subsequent changes in its fair value in earnings. When it is probable that a forecasted transaction will not occur, Vector discontinues hedge accounting and recognizes immediately in earnings gains and losses that were accumulated in other comprehensive income.

Deferred Financing Costs

Deferred financing costs represent loan fees and other related costs incurred in obtaining the debt financing currently in place, which are being amortized over the term of the related debts and are recorded within prepaid expenses and other current assets and other noncurrent assets on the consolidated balance sheets.

Accumulated Other Comprehensive Income

Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale investments, changes in fair value of certain hedges, defined benefit pension plans, and unrealized losses related to factors other than credit on fixed income securities are reported as a separate component on the equity section of the consolidated balance sheet. Such items, along with net income, are components of comprehensive income and are reflected in the consolidated statement of comprehensive income (loss).

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Changes in the balances of each component of accumulated other comprehensive income, net of tax, at December 31 are as follows:

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	UNREALIZED GAINS ON AVAILABLE-FOR-SALE SECURITIES	CASH FLOW HEDGE	DEFINED BENEFIT PENSION PLAN	ACCUMULATED OTHER COMPREHENSIVE INCOME
Balance, January 1, 2017	\$ 52,893	\$ —	\$ (1,897)	\$ 50,996
Other comprehensive income (loss) before reclassifications	28,226	(30)	203	28,399
Reclassification of the stranded tax effects as a result of the Tax Reform Act	15,920	—	(352)	15,568
Amounts reclassified from accumulated other comprehensive income (loss)	(9,013)	399	60	(8,554)
Balance, December 31, 2017	88,026	369	(1,986)	86,409
Other comprehensive income (loss) before reclassifications	(25,437)	219	66	(25,152)
Amounts reclassified from accumulated other comprehensive income (loss)	(7,944)	160	67	(7,717)
Balance, December 31, 2018	\$ 54,645	\$ 748	\$ (1,853)	\$ 53,540

The following table presents the effect of the reclassification of significant items out of accumulated other comprehensive income on the respective line items in the consolidated statement of operations for year ended December 31.

	AMOUNT RECLASSIFIED FROM ACCUMULATED OTHER COMPREHENSIVE INCOME		AFFECTED LINE ITEM IN THE CONSOLIDATED STATEMENT OF OPERATIONS
	2018	2017	
Unrealized gain on securities available for sale			
Realized gains on sale of securities	\$ 10,056	\$ 13,866	NET REALIZED GAINS ON INVESTMENTS
Loss on cash flow hedges			
Interest rate derivative contracts	(203)	(614)	INTEREST EXPENSE
Change in retirement plan liabilities adjustment			
Amortization of actuarial losses	(85)	(92)	(a)
Total reclassifications before income tax expense	9,768	13,160	
Less: Income tax expense	2,051	4,606	
Total reclassifications net of income tax expense	\$ 7,717	\$ 8,554	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost. See Note 12 to the consolidated financial statements for further detail.

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Legal Matters

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

Recently Issued Accounting Pronouncements

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This ASU amends and simplifies existing guidance in order to allow companies to more accurately present the economic effects of risk management activities in the financial statements. This ASU is effective for the Company beginning in fiscal year 2020. The Company is in the process of assessing the impact this ASU will have on its consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force), which provides new guidance intended to clarify the presentation of certain cash flow items including debt prepayments, debt extinguishment costs, contingent considerations payments, and insurance proceeds, among other things. This ASU is effective for the Company beginning in fiscal year 2019, with early adoption permitted. The Company is in the process of assessing the impact this ASU will have on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Measurement of Credit Losses on Financial Instruments (Topic 326), which requires financial assets measured at amortized cost to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This ASU is effective for annual periods beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted for annual and interim periods beginning after December 15, 2018. The Company is currently assessing the effect that this ASU will have on its results of operations, financial position and cash flows

In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principle versus Agent Considerations (Reporting Revenue Gross versus Net), which coincides with ASU 2014-09, Revenue from Contracts with Customers (Topic 606), and provides additional guidance in the determination of principals versus agents. ASU 2014-09 provides guidance to all entities in order to establish a common revenue standard for companies entering into contracts with customers for the transfer of goods or services or entering into contracts for the transfer of nonfinancial assets. This ASU requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard prescribes a five step model for recognizing revenue, the application of which will require significant judgment. An entity should disclose sufficient quantitative and qualitative information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. These ASUs are effective for the Company beginning in fiscal year 2019. The Company is in the process of assessing the impact this ASU will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016- 02, Leases (Topic 842), which provides new guidance on how an entity should account for leases and recognize associated lease assets and liabilities. This ASU requires lessees to recognize assets and liabilities that arise from financing and operating leases on the consolidated balance sheet. The implementation of this standard will require application of the new guidance at the beginning of the earliest comparative period presented, once adopted. This ASU is effective for the Company beginning in fiscal

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year 2020, with early adoption is permitted. The Company is in the process of assessing the impact this ASU will have on its consolidated financial statements.

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In January 2016, the FASB issued ASU No. 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10), which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (g) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (h) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. This ASU is effective for annual periods beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the effect that this ASU will have on its consolidated financial statements.

Revision of Previously Issued Financial Statements

The Company identified certain income statement reclassification items that needed to be revised in the consolidated financial statements for the year ended December 31, 2017 that consisted of the classification from cost of sales of \$3.9 million to selling, general and administrative expenses. The Company does not believe the revisions are material, either individually or in the aggregate to the December 31, 2017 consolidated financial statements.

Subsequent Events

In preparing these consolidated financial statements, management has evaluated events and transactions for potential recognition or disclosure through March 1, 2019, the date the consolidated financial statements were available to be issued.

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Note 2: Investments

The cost or amortized cost and estimated fair values of investments at December 31 are as follows:

	2018			
	COST OR AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 11,211	\$ 63	\$ (8)	\$ 11,266
Obligations of states and political subdivisions	41,579	1,901	(41)	43,439
Corporate securities	37,452	255	(152)	37,555
Mortgage-backed and asset- backed securities	61,158	955	(351)	61,762
Total fixed income securities	151,400	3,174	(552)	154,022
Preferred stocks	623	147	(136)	634
Common stocks	161,668	74,769	(5,099)	231,338
Total	\$ 313,691	\$ 78,090	\$ (5,787)	\$ 385,994
	2017			
	COST OR AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,255	\$ 33	\$ (1)	\$ 1,287
Obligations of states and political subdivisions	78,363	4,293	(3)	82,653
Corporate securities	25,731	808	(39)	26,500
Mortgage-backed and asset- backed securities	45,706	959	(161)	46,504
Total fixed income securities	151,055	6,093	(204)	156,944
Preferred stocks	623	169	(21)	771
Common stocks	165,624	102,376	(321)	267,679
Total	\$ 317,302	\$ 108,638	\$ (546)	\$ 425,394

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Other investments in limited partnerships are classified as available for sale and carried at fair value in the consolidated balance sheet as follows:

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	COST		ESTIMATED FAIR VALUE	
	2018	2017	2018	2017
Other Invested Assets	\$ 40,082	\$ 34,833	\$ 36,448	\$ 37,675

The amortized cost and estimated fair value of fixed income securities and convertible bonds at December 31, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or repayment penalties.

	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	\$ 5,391	\$ 5,391
Due after one year through five years	52,536	53,211
Due after five years through ten years	21,621	21,841
Due after ten years	25,650	26,959
	105,198	107,402
Mortgage-backed and asset-backed securities	61,158	61,762
Total	\$ 166,356	\$ 169,164

Net realized gains on investments consisted of the following:

	2018	2017
Realized gains on investments	\$ 24,656	\$ 20,353
Realized losses on investments	(14,404)	(6,193)
Change in fair value of convertible securities	(2,071)	561
Other-than-temporary impairment charges	(224)	(347)
	\$ 7,957	\$ 14,374

The 2018 other-than-temporary impairment charges noted above related to an investment in an oil and gas related limited partnership, mortgage-backed security and corporate bond. The 2017 other-than-temporary impairment charges noted above related to an investment in an oil and gas related limited partnership. The charge related to the limited partnership caused resulted from a reduction in the GAAP book value of the limited partnership caused by impairment charges to partnership assets.

The Company had on deposit, as required by various state regulatory agencies, fixed income securities with a fair value of \$3,101 and \$3,165 and cash equivalents of \$706 and \$148 at December 31, 2018 and 2017, respectively.

As of December 31, 2018 and 2017, the Company's investment portfolio had gross unrealized losses of \$5,787 and \$546, respectively. For securities that were in an unrealized loss position as of December 31, the lengths of time that such securities have been in an unrealized loss position, as measured by their year-end fair values, are as follows:

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	LESS THAN 12 MONTHS		12 MONTHS OR MORE		TOTAL	
	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
December 31, 2018:						
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,337	\$ (8)	\$ —	\$ —	\$ 1,337	\$ (8)
Obligations of states and political subdivisions	2,012	(37)	79	(4)	2,091	(41)
Corporate securities	9,384	(133)	1,010	(19)	10,394	(152)
Mortgage-backed and asset-backed securities	23,895	(296)	2,466	(55)	26,361	(351)
Total fixed income securities	36,628	(474)	3,555	(78)	40,183	(552)
Preferred stocks	—	—	465	(136)	465	(136)
Common stocks	50,336	(4,963)	2,037	(136)	52,373	(5,099)
Total	\$ 86,964	\$ (5,437)	\$ 6,057	\$ (350)	\$ 93,021	\$ (5,787)

	LESS THAN 12 MONTHS		12 MONTHS OR MORE		TOTAL	
	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
December 31, 2017:						
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 898	\$ (1)	\$ —	\$ —	\$ 898	\$ (1)
Obligations of states and political subdivisions	527	(3)	—	—	527	(3)
Corporate securities	500	(1)	4,083	(38)	4,583	(39)
Mortgage-backed and asset-backed securities	9,331	(58)	7,600	(103)	16,931	(161)
Total fixed income securities	11,256	(63)	11,683	(141)	22,939	(204)
Preferred stocks	—	—	579	(21)	579	(21)
Common stocks	14,586	(162)	846	(159)	15,432	(321)
Total	\$ 25,842	\$ (225)	\$ 13,108	\$ (321)	\$ 38,950	\$ (546)

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There were 85 and 53 fixed income securities in an unrealized loss position as of December 31, 2018 and 2017, respectively. In management's opinion, the unrealized losses on fixed income securities reflect general market conditions. Management believes that the unrealized losses are temporary. The Company does not intend to sell these securities prior to maturity or market recovery, and it is more likely than not the Company has the ability to hold these securities until maturity or market recovery. Management performed cash flow testing on its mortgage-backed and asset-backed securities and based on this cash flow testing all principal of these securities was deemed to be recoverable at December 31, 2018. There were 90 and 22 common and preferred stocks in an unrealized loss position as of December 31, 2018 and 2017, respectively. Management believes that the unrealized losses on common and preferred stocks reflect general market conditions and has the intent and ability to hold these common and preferred stocks to market price recovery of original cost.

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Note 3: Fair Value Measurements

The Company measures fair value by categorizing assets and liabilities based upon the level of judgment associated with the inputs to measure their fair value. These levels are:

- Level 1 - Inputs that are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
- Level 2 - Inputs other than quoted process included in Level 1 that are observable for the asset or liability through corroboration with market data at the measurement date.
- Level 3 - Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The fair values for securities included in Level 1 are based on observable inputs either directly or indirectly, such as quoted prices in markets that are active, quoted prices for similar securities at the measurement date; quoted prices in markets that are not active; or other inputs that are observable. The Company classifies its investment in U.S. Treasury securities and common stocks as Level 1 assets.

The fair values for securities included in Level 2 are based upon fair values generated by external pricing models that vary by asset class and incorporate available trade, bid and other market information, as well as price quotes from other independent market participants which reflect fair value of that particular security. The Company considers its investments in U.S. government agency bonds, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, and one convertible bond as Level 2 assets.

In classifying the mortgage-backed and asset-backed securities owned as Level 2 securities, the Company considers the inputs as follows:

- a. Quoted prices for similar assets or liabilities in active markets.
- b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the assets or liabilities, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets) or in which little information is released publicly (for example, a principal-to-principal market).

The Company's determination of the fair value of its interest rate swap as Level 2 is calculated using a discounted cash flow analysis based on the terms of the swap contract and the observable interest rate curve.

Securities included in Level 3 are securities where inputs are based solely on a broker price or unobservable market data. The Company classifies its investments in certain convertible bonds, convertible preferred stocks, and a closely held equity security as Level 3 assets.

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The fair value of the other invested assets (limited partnership interests) is determined by the investment company and is based upon fair value policies established by management of the underlying fund. Fair value policies at the underlying fund generally require the fund to utilize pricing/valuation information; however, in some instances current valuation information, for illiquid securities or securities in markets that are not active, may not be available from any third party source, or fund management may conclude that the valuations available from third party sources are not reliable. In these instances fund management may perform model-based analytical valuations that may be used to value these investments. The Company uses net asset value (NAV) per share (or its equivalent), as a practical expedient to estimate the fair value of its other invested assets, if NAV is calculated consistent with accounting principles generally accepted in the United States of America and sale of the investment at an amount different than NAV is not probable. The Company considered the nature, risk, and probability for the sale of the investment (at amounts different from NAV). The Company's considerations included (but were not limited to):

- Unfunded commitments (for additional investment)
- Redemption eligibility and frequency
- Required redemption notice

Based upon these considerations, the Company concluded that NAV for the other invested assets is calculated consistent with accounting principles generally accepted in the United States of America.

Investments carried at NAV may be adjusted based upon management's assumptions; therefore, any withdrawal, transfer, or sale of the limited partnership interest is subject to the general partner's discretion. At December 31, 2018 and 2017, the fair value using net asset value for the Company's other invested assets were \$36,448 and \$37,675, respectively.

One investment in a limited partnership included in other invested assets comprising 53% of other invested assets is subject to certain lock up provisions. This investment provides that the Company may not withdraw a capital contribution for months following the date of its initial investment. Following this one year lock up period, the Company, in order to make a withdraw, must provide 90 days' prior notice as of the last date of each calendar quarter to the general partner. Withdrawals made by the Company less than 36 months from initial contribution are subject to a 3% early withdrawal charge. These restrictions may be waived by the general partner in the case of certain events or at the discretion of the general partner. This partnership does not have a finite life.

One investment in a master limited partnership included in other invested assets comprising 29% of other invested assets contains a stipulation that redemptions by the Company within 12 months following its initial investment are subject to a 1% early withdrawal charge. This restriction may be waived by the managing member. The Company can make a withdrawal as of the last business day of the month by providing notice to the managing member at least 30 days in advance of the withdrawal. This partnership does not have a finite life.

One investment in a limited partnership comprising 14% of other invested assets has a term of seven years after the final closing, with an option for up to three additional one year periods at the discretion of the general partner.

One investment in a limited partnership included in other invested assets comprising 3% of other invested assets has a term of 10 years from the initial closing, with an option for up to two consecutive one year extensions at the general partner's election. A 90% in interest of the limited partners may elect to terminate the fund at any time. This limited partnership is not subject to lock up provisions.

One investment in a limited partnership included in other invested assets comprising 1% of other invested assets has a term of 10 years from the initial closing. This limited partnership is not subject to lock up provisions.

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The following table summarizes fair value measurements by level within the fair value hierarchy at December 31, 2018 and 2017 for assets and liabilities measured at fair value on a recurring basis:

2018				
FAIR VALUE MEASUREMENTS USING:				
DESCRIPTION	TOTAL	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Assets				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 11,266	\$ 11,266	\$ —	\$ —
Obligations of states and political subdivisions	43,439	—	43,439	—
Corporate securities	37,555	—	37,555	—
Mortgage-backed and asset-backed securities	61,762	—	61,762	—
Total fixed income securities	154,022	11,266	142,756	—
Convertible bonds	15,142	—	8,782	6,360
Preferred stocks	634	—	—	634
Convertible preferred stocks	1,425	—	—	1,425
Common stocks	231,338	231,228	—	110
Total bonds and stocks	\$ 402,561	\$ 242,494	\$ 151,538	\$ 8,529
Interest rate swap receivable	\$ 947	\$ —	\$ 947	\$ —
2017				
FAIR VALUE MEASUREMENTS USING:				
DESCRIPTION	TOTAL	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Assets				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,287	\$ 1,287	\$ —	\$ —
Obligations of states and political subdivisions	82,653	—	82,653	—
Corporate securities	26,500	—	26,500	—
Mortgage-backed and asset-backed securities	46,504	—	46,504	—
Total fixed income securities	156,944	1,287	155,657	—
Convertible bonds	15,816	—	13,348	2,468
Preferred stocks	771	—	192	579
Convertible preferred stocks	1,701	—	—	1,701
Common stocks	267,679	267,573	—	106
Total bonds and stocks	\$ 442,911	\$ 268,860	\$ 169,197	\$ 4,854
Interest rate swap receivable	\$ 467	\$ —	\$ 467	\$ —

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For fair value measurements using Level 3 inputs, a reconciliation of the beginning and ending balances is as follows at December 31:

	2018					TOTAL
	FIXED INCOME SECURITIES	CONVERTIBLE BONDS	PREFERRED STOCKS	CONVERTIBLE PREFERRED STOCKS	COMMON STOCKS	
Balance, January 1, 2018	\$ —	\$ 2,468	\$ 579	\$ 1,701	\$ 106	\$ 4,854
Purchases	—	5,603	—	—	—	5,603
Sales	—	(170)	—	—	—	(170)
Distributions:						
Transfers in from Level 2	—	—	169	—	—	169
Transfers out to Level 2	—	(710)	—	(275)	—	(985)
Total gains (losses):						
Included in earnings (reported in net realized gains on investments)	—	(8)	—	—	—	(8)
Included in other comprehensive loss	—	(823)	(114)	(1)	4	(934)
Balance, December 31, 2018	\$ —	\$ 6,360	\$ 634	\$ 1,425	\$ 110	\$ 8,529

	2017					TOTAL
	FIXED INCOME SECURITIES	CONVERTIBLE BONDS	PREFERRED STOCKS	CONVERTIBLE PREFERRED STOCKS	COMMON STOCKS	
Balance, January 1, 2017	\$ —	\$ 4,662	\$ 528	\$ 2,261	\$ 100	\$ 7,551
Purchases	—	2,451	—	78	—	2,529
Sales	—	—	—	—	—	—
Distributions:						
Transfers in from Level 2	—	—	—	—	—	—
Transfers out to Level 2	—	(4,520)	—	(638)	—	(5,158)
Total gains (losses):						
Included in earnings (reported in net realized gains on investments)	—	—	—	—	—	—
Included in other comprehensive income	—	(125)	51	—	6	(68)
Balance, December 31, 2017	\$ —	\$ 2,468	\$ 579	\$ 1,701	\$ 106	\$ 4,854

The Company's policy is to transfer assets and liabilities into and out of Level 3 at the beginning of the reporting period when the circumstance is such that significant inputs can or cannot be corroborated with market observable data.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2018 and 2017. The fair value of a financial instrument is the amount that would be paid to transfer an asset or a liability in an orderly transaction between market participants at the measurement date.

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	2018		2017	
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE
Financial assets:				
Insurance Group				
Investments:				
Fixed income securities	\$ 154,022	\$ 154,022	\$ 156,944	\$ 156,944
Convertible bonds	15,142	15,142	15,816	15,816
Preferred stocks	634	634	771	771
Convertible preferred stocks	1,425	1,425	1,701	1,701
Common stocks	231,338	231,338	267,679	267,679
Other invested assets	36,448	36,448	37,675	37,675
Cash and cash equivalents	20,732	20,732	11,071	11,071
Accrued income from investments	1,453	1,453	1,704	1,704
Security Group:				
Cash and cash equivalents	613	613	833	833
Trade accounts receivable	22,886	22,886	21,642	21,642
Prepaid expenses and other current assets	7,418	7,418	7,292	7,292
Interest rate swap receivable	947	947	467	467
Financial liabilities:				
Security Group:				
Accounts payable and accrued expenses	37,819	37,819	32,640	32,640
Customer deposits	760	760	586	586
Long-term debt and current maturities thereof	\$ 125,010	\$ 125,010	\$ 148,077	\$ 148,077

The carrying amounts shown in the table are included in the consolidated balance sheet under the indicated captions.

Cash and cash equivalents, other receivables, trade accounts receivable, accrued income from investments, accounts payable, and accrued expenses - the carrying amounts at face value approximate fair value because of the short maturity of these instruments.

Interest rate swap payable – The Company's determination of the fair value of its interest rate swap is calculated using a discounted cash flow analysis based on the terms of the swap contract and the observable interest rate curve (Level 2 inputs).

The fair values of the financial instruments shown in the above table as of December 31, 2018 and 2017 represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Company's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Company based on the best information available in the circumstances.

The fair value of long-term debt is estimated by discounting the future cash flows of each issuance at rates that the Company could obtain similar debt instruments of comparable maturities.

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30 The Security Group has assets and liabilities that are required to be recorded at fair value on a nonrecurring basis when certain circumstances occur. In the case of intangible assets, upon the occurrence of an event or change in circumstance that may indicate that the fair value of a customer service agreement is less than its carrying value, the Company determines the fair value of the specific customer service agreement and records an impairment for the amount by which the carrying value exceeds the customer service agreement's fair value. The estimate of fair value of a customer service agreement is determined using Level 3 inputs, primarily an analysis of future expected cash flows. The Company recorded impairment expense, through amortization expense, on their customer service agreements of \$1,999 and \$1,290 during 2018 and 2017, respectively.

Note 4: Liability for Unpaid Losses and Loss Adjustment Expenses

Activity in unpaid losses and loss adjustment expenses is summarized as follows:

	<u>2018</u>	<u>2017</u>
Balance as of January 1	\$ 90,452	\$ 91,527
Less reinsurance recoverable	(12,730)	(12,307)
Net balance at January 1	<u>77,722</u>	<u>79,220</u>
Incurred related to:		
Current year	115,858	83,913
Prior years	(5,075)	(3,175)
Total incurred	<u>110,783</u>	<u>80,738</u>
Paid related to:		
Current year	77,885	51,501
Prior years	27,361	30,735
Total paid	<u>105,246</u>	<u>82,236</u>
Net balance as of December 31	<u>83,259</u>	<u>77,722</u>
Plus reinsurance recoverable	<u>13,299</u>	<u>12,730</u>
Balance at December 31	<u>\$ 96,558</u>	<u>\$ 90,452</u>

Due to changes in estimates of insured events in prior years, the Insurance Group decreased the liability for unpaid losses and loss adjustment expenses relative to prior accident years in 2018 and 2017 by \$5,075 and \$3,175, respectively. The decrease in 2018 is due to better than expected development of losses incurred, primarily in the homeowners liability and other liability segments, and primarily related to the 2014, 2016 and 2017 accident years. The decrease in 2017 is due to better than expected development of losses incurred, primarily in the homeowners property and special property lines of business, and primarily related to accident years 2016 and 2015.

The following tables present information about incurred and paid claims development as of December 31, 2018 net of reinsurance, as well as cumulative claim frequency and the total of IBNR reserves plus expected development on reported claims that the Insurance Group included in unpaid losses and loss adjustment expenses as of December 31, 2018. The tables include unaudited information about incurred and paid claims development for the years ended December 31, 2013 through 2016, which is presented as required supplementary information.

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Homeowners

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance

ACCIDENT YEAR	UNAUDITED						AS OF DECEMBER 31, 2018	
	2013	2014	2015	2016	2017	2018	TOTAL IBNR PLUS EXPECTED ON REPORTED	CUMULATIVE NUMBER OF REPORTED CLAIMS
2009	\$ 41,504	\$ 41,460	\$ 41,676	\$ 41,564	\$ 41,624	\$ 41,573	\$ 81	5,077
2010	53,227	52,756	52,517	52,517	52,460	52,408	110	7,516
2011	61,459	60,873	61,047	60,795	60,681	60,716	70	10,640
2012	55,576	54,401	53,961	54,692	54,486	54,485	90	12,396
2013	49,259	47,510	44,736	45,123	44,610	44,338	200	4,835
2014		67,879	64,035	64,722	64,678	63,785	414	7,009
2015			59,902	55,851	54,839	54,783	1,499	5,528
2016				51,560	51,007	49,720	1,902	5,333
2017					52,190	52,034	3,618	6,012
2018						78,829	9,487	8,771
						<u>Total</u>		<u>\$552,671</u>

Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance

ACCIDENT YEAR	UNAUDITED					
	2013	2014	2015	2016	2017	2018
2009	\$ 40,943	\$ 40,976	\$ 41,001	\$ 41,268	\$ 41,304	\$ 41,281
2010	51,256	51,674	52,218	52,264	52,258	52,266
2011	57,054	58,473	60,365	60,484	60,566	60,572
2012	48,722	50,337	52,226	53,998	54,256	54,319
2013	29,281	39,921	41,195	42,637	43,946	43,867
2014		48,758	56,644	59,671	62,226	63,191
2015			40,780	49,251	51,165	52,116
2016				35,608	44,198	45,782
2017					33,973	44,966
2018						55,747
					<u>Total</u>	<u>\$514,107</u>
					All outstanding liabilities before 2009, net of reinsurance	<u>9,002</u>
					Liabilities for losses and loss adjustment expenses, net of reinsurance	<u>\$47,566</u>

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Other Liability

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance

ACCIDENT YEAR	UNAUDITED						AS OF DECEMBER 31, 2018	
	2013	2014	2015	2016	2017	2018	TOTAL IBNR PLUS EXPECTED ON REPORTED	CUMULATIVE NUMBER OF REPORTED CLAIMS
2009	\$ 7,670	\$ 7,705	\$ 8,018	\$ 7,865	\$ 7,887	\$ 7,879	\$ 14	291
2010	5,965	6,405	6,062	6,078	6,061	6,056	14	271
2011	7,202	7,576	8,039	7,807	7,763	7,763	23	304
2012	6,572	6,327	5,200	5,555	5,556	5,524	31	238
2013	7,333	7,133	7,562	7,678	7,869	7,968	115	246
2014		6,909	8,493	10,031	10,554	10,242	463	262
2015			7,888	8,125	8,108	8,016	1,346	255
2016				7,264	7,171	6,851	1,979	194
2017					6,792	6,464	3,176	149
2018						6,685	4,786	113
						<u>Total</u>	<u>\$73,448</u>	

Other Liability

Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance

ACCIDENT YEAR	UNAUDITED						Total
	2013	2014	2015	2016	2017	2018	
2009	\$ 6,748	\$ 6,929	\$ 7,375	\$ 7,669	\$ 7,715	\$ 7,715	\$ 7,715
2010	4,046	5,682	5,920	6,032	6,032	6,032	6,032
2011	2,644	6,137	7,153	7,740	7,740	7,740	7,740
2012	988	2,721	4,256	5,079	5,197	5,493	5,493
2013	191	770	2,357	5,473	7,282	7,800	7,800
2014		20	1,484	4,338	8,209	9,474	9,474
2015			174	904	3,414	5,559	5,559
2016				167	1,146	2,819	2,819
2017					75	770	770
2018						104	104
						<u>Total</u>	<u>\$ 53,506</u>
						All outstanding liabilities before 2009, net of reinsurance	<u>3,314</u>
						Liabilities for losses and loss adjustment expenses, net of reinsurance	<u>\$ 23,256</u>

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The reconciliation of the net incurred and paid loss development tables to the liability for losses and loss adjustment expenses in the consolidated balance sheets is as follows:

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	<u>DECEMBER 31, 2018</u>
Net outstanding liabilities	
Homeowners	\$ 47,566
Other liability	23,256
Other short-duration insurance lines	<u>7,987</u>
Liabilities for unpaid losses and allocated loss adjustment expenses, net of reinsurance	78,809
Reinsurance recoverable on unpaid claims	
Homeowners	8,883
Other liability	1,706
Other short-duration insurance lines	<u>2,710</u>
Total reinsurance recoverable on unpaid losses	13,299
Unallocated loss adjustment expenses	<u>4,450</u>
Total gross liability for unpaid losses and loss adjustment expenses	<u><u>\$ 96,558</u></u>

The methods used to select the estimated claim reserves include the loss ratio method, loss development methods, the Bornhuetter-Ferguson (B-F) method, and the Berquist-Sherman (B-S) method, applied to paid losses and incurred losses. Cumulative claim frequency was calculated using the sum of all individual claimants. Claims that were presented to the Company, investigated, and ultimately closed without any loss or loss adjustment expense payments would be included in the cumulative claim frequency information shown above.

There were no changes in methodology from the prior year.

The following is supplementary information about average historical claims duration as of December 31, 2018.

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance

	<u>UNAUDITED</u>					
Years	1	2	3	4	5	6
Homeowners	69.9%	18.1%	4.3%	3.4%	2.3%	0.3%
Other Liability	0.6%	12.0%	22.6%	30.6%	15.0%	4.0%

Note 5: Reinsurance

The Insurance Group purchases quota share and per risk and catastrophic excess of loss reinsurance. The Insurance Group remains contingently liable in the event that the reinsurer is unable to meet its obligations assumed under the reinsurance agreements.

The Insurance Group had no assumed premiums earned in 2018 and 2017 and had ceded premiums earned in 2018 and 2017 of \$17,460 and \$15,832, respectively. Losses and loss adjustment expenses are net of reinsurance recoveries of \$7,413 and \$5,968 in 2018 and 2017,

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34 respectively. Amounts paid to reinsurers related to the unexpired portion of reinsured contracts were \$2,793 and \$2,388 as of December 31, 2018 and 2017, respectively.

The Insurance Group had no significant concentration in risk from any one unaffiliated reinsurer as of December 31, 2018 and 2017.

Note 6: Dividends from Subsidiaries and Statutory Financial Information

The Contributionship and its subsidiaries prepare statutory financial statements in accordance with accounting practices prescribed or permitted by the Pennsylvania Insurance Department. The Commonwealth of Pennsylvania requires that insurance companies domiciled in the Commonwealth of Pennsylvania prepare their statutory financial statements in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures manual, subject to any deviations prescribed or permitted by the Commonwealth of Pennsylvania Insurance Commissioner. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future.

The Contributionship and its subsidiaries are restricted by law as to the amount of dividends they may pay without the approval of regulatory authorities. During 2019, the maximum amount of dividends that can be paid by the Contributionship without such approval is \$27,042. The Contributionship paid no ordinary dividends during 2018 and 2017.

The surplus of the Contributionship and its subsidiaries, as determined in accordance with statutory accounting practices, is \$270,422 and \$300,226 at December 31, 2018 and 2017, respectively. The net (loss) income of the Contributionship and its subsidiaries, as determined in accordance with statutory accounting practices, is (\$112) and \$18,015 for the years ended December 31, 2018 and 2017, respectively.

Risk-based capital is designed to measure the acceptable amount of capital an insurer should have based on the inherent risks of the insurer's business. Insurers failing to meet adequate capital levels may be subject to insurance department scrutiny and ultimately rehabilitation or liquidation. As of December 31, 2018 and 2017, the Contributionship and its subsidiaries maintained statutory-basis surplus in excess of the minimum prescribed risk-based capital requirements. As of December 31, 2018 and 2017, the Contributionship and its subsidiaries were in compliance with the minimum capital requirements under Commonwealth of Pennsylvania regulations.

Note 7: Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the years ended December 31 are as follows:

	2018	2017
Balance as of January 1	\$ 25,796	\$ 30,438
Amortization	<u>(4,642)</u>	<u>(4,642)</u>
Balance as of December 31	<u>\$ 21,154</u>	<u>\$ 25,796</u>

The amortization period for goodwill is 10 years.

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The following summarizes the gross carrying amount and accumulated amortization of intangible assets as of December 31:

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	2018		2017	
	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION
Customer service agreements	\$ 252,490	\$ 146,752	\$ 286,671	\$ 160,620
Customer relationships	10,460	4,325	10,460	3,520
Covenants not to compete	728	659	750	600
Covenants not to solicit	2,084	1,400	2,084	1,140
Technology	2,740	2,740	2,740	2,397
Trade Names	669	669	669	585
Total	\$ 269,171	\$ 156,545	\$ 303,374	\$ 168,862

Amortization expense, excluding impairment charges, for other intangible assets was \$29,287 and \$29,958 for the years ended December 31, 2018 and 2017, respectively.

The estimated amortization expense for goodwill and other intangible assets for each of the five succeeding fiscal years is as follows:

2019	\$ 30,932
2020	29,404
2021	26,526
2022	22,458
2023	15,501
Thereafter	8,959
Total	\$ 133,780

Note 8: Acquisitions

Guardian Force Security Services, LLC

On May 31, 2017, Vector acquired selected assets and assumed certain liabilities of Guardian Force Security Services, LLC (GFSS) located in Texas for a purchase price of \$2,490. The results of GFSS have been included in the consolidated financial statements since the acquisition date. The assets acquired represent approximately 2,000 customer accounts. The transaction was accounted for as an asset acquisition.

The aggregate purchase price of \$2,490 included \$2,525 of intangible assets and \$55 of tangible and current assets and \$75 of noncurrent assets, net of \$165 in current liabilities. The \$2,525 of intangible assets was assigned to customer service agreements, which are amortized over 13 years.

Funding for the acquired assets and assumed liabilities consisted primarily of \$2,190 in borrowings on Vector's existing revolving credit facility and \$300 in the form of a purchase holdback. The payment of the purchase holdback is contingent upon attrition of accounts over the first year and a payment of \$14 was made in 2018 to settle the purchase holdback obligation.

Security Associates, LLC

On August 9, 2017, Vector acquired selected assets and assumed certain liabilities of Security Associates, LLC (Security Associates) located in Maryland for a purchase price of \$10,392. The results of Security Associates have been included in the consolidated financial statements since the acquisition date. The assets acquired represent approximately 9,000 customer accounts. The transaction was accounted for as an asset acquisition.

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36 The aggregate purchase price of \$10,392 included \$10,923 of intangible assets and \$63 of tangible and current assets and \$43 of noncurrent assets, net of \$637 in current liabilities. Of the \$10,923 of intangible assets, \$10,873 was assigned to customer service agreements, which are amortized over 13 years, and \$50 was assigned to covenants not to compete, which are amortized over 5 years.

Funding for the acquired assets and assumed liabilities consisted primarily of \$8,763 in borrowings on Vector's existing revolving credit facility and \$1,629 in the form of a purchase holdback. The payment of the purchase holdback is contingent upon attrition of accounts over the first year and a payment of \$682 was made in 2018 to settle the purchase holdback obligation.

Others

Vector acquired selected accounts from various Company authorized dealers located in various states. The total purchase price for these accounts was \$10,753 and \$12,532 in 2018 and 2017, respectively. The revenue and associated costs from the monitoring contracts acquired in these transactions have been included in the consolidated financial statements since the acquisition dates. The assets acquired represent approximately 6,900 accounts in 2018 and 8,700 accounts in 2017. The entire aggregate purchase price was assigned to customer service agreements, which are amortized over 7 years. Substantially all accounts are subject to a one year holdback period of approximately 10% of the purchase price. The transaction was accounted for as an asset acquisition.

Note 9: Borrowings and Credit Arrangements

Long-term debt as of December 31 consists of the following:

	2018	2017
Revolving credit facility - variable interest rate (approximately 4.0% and 2.9% as of December 31, 2018 and 2017, respectively)	\$ 122,627	\$ 144,944
Capital leases - bearing interest at rates ranging from 3% to 7% as of December 31, 2018 and 2017	2,383	3,133
	125,010	148,077
Less current maturities	(1,489)	(1,750)
Total long-term debt	\$ 123,521	\$ 146,327

Vector has a \$300,000 revolving credit facility that permits Vector to borrow, on a revolving basis, through November 9, 2021. Interest on the entire \$300,000 credit facility is computed at either a base rate or LIBOR rate plus a scaling interest rate spread based upon a total consolidated indebtedness to eligible recurring monthly revenue ratio (Leverage Ratio), as defined in the agreement. Borrowings under this loan agreement are collateralized by Vector's assets, including the customer service agreements.

On January 13, 2017, Vector entered into a 48 month interest rate swap agreement with a notional amount of \$70 million. This derivative was designated as a cash flow hedge and is recognized on the consolidated balance sheet at its fair value. Changes in fair value are recorded in other comprehensive income, net of taxes. Under the terms of the swap agreement, Vector receives variable rate interest payments based on 30 day LIBOR and makes fixed rate payments of 1.81%. The fair value of the swap as of December 31, 2018 and 2017 was \$947 and \$467, respectively and was recorded as an asset in the consolidated financial statements.

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Vector must pay a quarterly commitment fee based on the Leverage Ratio that ranges from 0.2% to 0.3%. At December 31, 2018, Vector was paying a quarterly commitment fee of approximately 0.2% on the available unused portion of the revolving credit facility. As of December 31, 2018, the available unused portion of the revolving credit facility was \$174,902.

Under Vector's revolving credit facility, approximately \$2,471 were committed for outstanding letters of credit as of December 31, 2018 and 2017. There were no amounts drawn on the letters of credit as of December 31, 2018 and 2017.

The credit agreement contains covenants with respect to, among other things, the maintenance of specified financial ratios. These provisions, if violated, could terminate the agreement and cause an acceleration of the maturity date. As of December 31, 2018 and 2017, the Company was in compliance with all such covenants.

The aggregate maturities of debt principal for Vector as of December 31, 2018 are as follows:

2019	\$ 1,489
2020	715
2021	122,803
2022	3
Total	<u><u>\$ 125,010</u></u>

Note 10: Leases

Vector has various capital leases for equipment (Note 9) that expire at various dates during the next 40 months. Amortization of assets held under capital leases is included with depreciation expense.

Vector leases certain equipment and office space under various operating leases. The future minimum rental commitments for all such noncancelable leases as of December 31, 2018 are as follows:

2019	\$ 3,438
2020	2,569
2021	1,628
2022	1,518
2023	1,234
Thereafter	714
Total	<u><u>\$ 11,101</u></u>

Rent expense for leased equipment and office space totaled \$6,234 and \$6,438 for the years ended December 31, 2018 and 2017, respectively.

Note 11: Income Taxes

Income tax (benefit) expense for the years ended December 31 consists of:

2018			2017		
CURRENT	DEFERRED	TOTAL	CURRENT	DEFERRED	TOTAL
<u><u>\$ 52</u></u>	<u><u>\$ (1,606)</u></u>	<u><u>\$ (1,554)</u></u>	<u><u>\$ 7,314</u></u>	<u><u>\$ (6,942)</u></u>	<u><u>\$ 372</u></u>

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The expected income tax (benefit) expense for the years ended December 31 differed from the amounts computed by applying the U.S. federal income tax rate of 21% as follows:

	2018	2017
Computed "expected" income tax expense	\$ (756)	\$ 8,158
Increase (decrease) in income taxes resulting from:		
Tax-exempt interest	(276)	(621)
Dividends received deduction	(332)	(813)
State taxes, net of federal benefit	239	(110)
Provision to return adjustments	(357)	(42)
Change in federal income tax rate	—	(6,325)
Other, net	(72)	125
	<u>\$ (1,554)</u>	<u>\$ 372</u>

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

	2018	2017
Insurance Group:		
Deferred income tax asset components:		
Unearned premiums and advance premiums	\$ 3,527	\$ 3,230
Unpaid losses and loss adjustment expenses	1,086	1,035
Other-than-temporary impairments	986	965
Accrued pension liability	493	528
Deferred compensation	839	835
Other	319	153
Total deferred income tax asset	<u>7,250</u>	<u>6,746</u>
Deferred income tax liability components:		
Deferred acquisition costs	(3,536)	(3,322)
Unrealized investment gains	(14,419)	(23,295)
Unrealized investment gains on convertible securities	—	(341)
Other	(1,646)	(1,728)
Total deferred income tax liability	<u>(19,601)</u>	<u>(28,686)</u>
Net deferred income tax liability	<u>\$ (12,351)</u>	<u>\$ (21,940)</u>
Security Group:		
Deferred income tax asset components:		
Accrued expenses	\$ 2,463	\$ 2,198
Deferred rent	31	57
Inventories and accounts receivable	759	890
Intangible assets	23,787	21,920
HSS deferred revenue	1,188	877
Total deferred tax asset	<u>28,228</u>	<u>25,942</u>
Deferred income tax liability components:		
Unbilled revenue	(1,924)	(2,544)
Interest rate swap	(199)	(98)
Plant and equipment	(4,840)	(3,328)
HSS deferred charges	(3,170)	(2,632)
Total deferred income tax liability	<u>(10,133)</u>	<u>(8,602)</u>
Net deferred income tax asset	<u>\$ 18,095</u>	<u>\$ 17,340</u>

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On December 22, 2017, H.R.1, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (the "Act"), was enacted by the U.S. federal government. The Act provides for significant changes to corporate taxation including the decrease of the corporate tax rate to 21%. The Company has accounted for the material impacts of the Act by remeasuring its deferred tax assets/(liabilities) at the 21% enacted tax rate.

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Deferred tax assets/(liabilities) related to available for sale securities gains/(losses) that were remeasured due to the Act resulted in a stranded tax effect within Accumulated Other Comprehensive Income ("AOCI"). This is due to the effect of the tax rate change being recorded through continuing operations as required under Accounting Standards Codification 740. On February 14, 2018, Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220) – Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02"), which allows for the reclassification of the stranded tax effects as a result of the Act from AOCI to unassigned equity and requires certain other disclosures. The Company chose to early adopt the provisions of ASU 2018-12 and recorded a one-time reclassification of \$15,568 from AOCI to unassigned equity for the stranded tax effects resulting from the newly enacted corporate tax rate. The amount of the reclassification was the difference between the historical corporate tax rate and the newly enacted 21% corporate tax rate. See Consolidated Statement of Equity for details of the reclassification.

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. Management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The amount of the deferred income tax asset considered realizable; however, could be reduced in the near term if estimates of future taxable income or statutory tax rates are reduced during the carryforward period. Management has determined that it was not required to establish a valuation allowance against the net deferred income tax asset.

Vector has no remaining state net operating loss carryforwards, as they have been utilized in offsetting state taxable income as of December 31, 2018.

As of December 31, 2018 and 2017, the liability for unrecognized tax benefits was \$184 and \$0, respectively. The net change in liability was the result of Research and Development credits being claimed for the current and prior periods. The additions consist of \$46 relating to credits being claimed for the 2018 tax year and \$138 relating to credits being claimed for prior years as a result of the filing amended federal income tax returns.

There are no tax-related interest or penalties accrued on the consolidated balance sheet at December 31, 2018 and 2017, nor has any tax related interest or penalties been recognized in the consolidated statement of operations for the years ended December 31, 2018 and 2017.

The Company's federal income tax returns for tax years ended December 31, 2014 and prior are closed to examination.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2018 AND 2017

(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

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Note 12: Employee Benefit Plans

Defined Benefit Pension Plan

The Insurance Group made \$0 and \$300 contributions to the Plan in 2018 and 2017, respectively.

The components of the net periodic benefit cost are as follows:

	<u>2018</u>	<u>2017</u>
Interest cost	\$ 262	\$ 290
Expected return on plan assets	(504)	(447)
Amortization of net loss	85	92
Total net periodic benefit cost before settlement	<u>(157)</u>	<u>(65)</u>
Effect of settlement	326	—
Total net periodic benefit cost after settlement	<u>\$ 169</u>	<u>\$ (65)</u>

On December 13, 2006, the Board of Directors of the Company voted to freeze the benefits of the participants in the Plan effective April 1, 2007.

The Insurance Group recognizes the overfunded or underfunded status of its defined benefit pension plan as an asset (other assets) or liability (other liabilities) in the consolidated balance sheet. Changes in the funded status during any given period of time are recognized as a change in other comprehensive income.

The table set forth below reconciles the defined benefit pension plan's funded status reconciled with the amount in the consolidated balance sheet as of December 31:

	<u>2018</u>	<u>2017</u>
Benefit obligation as of January 1	8,027	\$ 7,912
Interest cost	262	290
Distributions	(1,504)	(478)
Change due to change in assumptions and experience	<u>(409)</u>	<u>303</u>
Benefit obligation as of December 31	<u>6,376</u>	<u>8,027</u>
Plan assets as of January 1	8,030	7,146
Employer contributions	—	300
Actual return on assets	(147)	1,062
Distributions	<u>(1,504)</u>	<u>(478)</u>
Plan assets as of December 31	<u>6,379</u>	<u>8,030</u>
Funded status	<u>\$ 3</u>	<u>\$ 3</u>

The net actuarial loss recognized in accumulated other comprehensive income, pre-tax in the consolidated balance sheet as of December 31 is as follows:

	<u>2018</u>	<u>2017</u>
	<u>\$ 2,346</u>	<u>\$ 2,514</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

Assumptions used in determining the actuarial present value of the projected benefit obligation were as follows at December 31:

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	2018	2017
Weighted-average discount rate	3.96%	3.35%
Expected long-term rate of return on assets	6.50	6.50
Rate of increase in compensation levels	N/A	N/A

The expected long-term rate of return on assets reflects the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. The selected rate considers the historical and expected future investment trends of the present and expected assets in the Plan.

There were \$1,504 and \$478 of benefit payments made under the Plan in 2018 and 2017, respectively. Expected payments under the Plan in future years are as follows at December 31, 2018:

2019	\$ 483
2020	476
2021	479
2022	478
2023	465
2024 - 2028	2,152

The Plan had approximately 66% and 74% of its investments invested in common stocks, 20% and 17% invested in corporate bonds and the remainder invested in U.S. Government and mortgage-backed securities and cash and cash equivalents for the year ending 2018 and 2017, respectively.

The following table provides the fair value measurements of the Plan assets by level within the fair value hierarchy at December 31. These assets are measured at fair value on a recurring basis.

DESCRIPTION	2018			
	TOTAL	FAIR VALUE MEASUREMENTS USING:		
		QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 454	\$ 454	\$ —	\$ —
Obligations of states and political subdivisions	254	—	254	—
Corporate securities	1,273	—	1,273	—
Total fixed income securities	1,981	454	1,527	—
Common stocks	4,182	4,182	—	—
	\$ 6,163	\$ 4,636	\$ 1,527	\$ —

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 DECEMBER 31, 2018 AND 2017

(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

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DESCRIPTION	2017			
	TOTAL	FAIR VALUE MEASUREMENTS USING:		
		QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 426	\$ 426	\$ —	\$ —
Obligations of states and political subdivisions	208	—	208	—
Corporate securities	1,356	—	1,356	—
Total fixed income securities	1,990	426	1,564	—
Common stocks	5,920	5,920	—	—
	\$ 7,910	\$ 6,346	\$ 1,564	\$ —

See Note 3 for additional information regarding the Company's categorization of fair value of financial instruments.

The remainder of Plan assets not included above are comprised of cash and cash equivalents.

The objective of the portfolio is to maximize the total rate of return while controlling investment risk and to ensure sufficient funding status of the Plan as actuarially determined by the total return objective.

The Plan's investment guidelines are as follows:

- No more than 5% of fixed income securities rated below "A" by either Standard and Poor's or Moody's may be purchased. None may be rated below "Baa."
- Average duration of bonds will range from 4 to 7 years, depending on the market outlook.
- Prohibitions
 - a) Unincorporated businesses
 - b) Private placements or direct mortgages without approval
 - c) Financial guarantees

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(DOLLARS IN THOUSANDS, UNLESS OTHERWISE NOTED)

Other Benefit Plans

The Company maintains other benefit plans, including defined contribution plans (401(k)), with a cash or deferred arrangement covering all employees meeting eligibility requirements. Participants may elect to contribute, on a pretax basis, up to the Internal Revenue Service limit. The Company's matching contributions were \$2,711 in 2018 and \$2,461 in 2017.

The Company has a voluntary deferred compensation plan for certain employees meeting Plan eligibility requirements (the Participants) under which salaries and annual incentive awards can be deferred. The Participants deferred receipt of \$1,085 and \$1,361 in 2018 and 2017, respectively. The Participants have the option of being paid at termination of employment or on the fifth March 1st immediately following the date on which the annual compensation or base salary would have been payable. The Company did not make any payments in 2017 and 2018. Amounts accrued under the plan were \$5,943 and \$4,519 as of December 31, 2018 and 2017, respectively.

The Company provides certain postretirement health care benefits. Net periodic postretirement benefit cost for 2018 and 2017 was \$18 and \$16, respectively.

For measurement purposes, health care cost trend increases do not affect the Company's costs due to the fact that the Company has limited the maximum dollar amount of benefits that will be paid. The weighted average discount rate used was 3.96% and 3.35% in 2018 and 2017, respectively.

Board of Directors
The Philadelphia Contributionship Mutual Holding Company

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of The Philadelphia Contributionship Mutual Holding Company and its subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations, comprehensive (loss) income, equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Philadelphia Contributionship Mutual Holding Company and its subsidiaries as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Required Supplemental Information

Accounting principles generally accepted in the United States of America, require that certain information for years 2013-2017 related to the Company's liability for losses and loss expense reserves in Note 4 on page 31-33 supplement the financial statements. Such information is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's response to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

BakerTilly Virchow Krause, LLP

Philadelphia, Pennsylvania
March 1, 2019

DIRECTORS & OFFICERS

DIRECTORS

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President, S. M. Jenkins & Co.
General Partner, Jenkins Partners, L.P.

Bruce M. Eckert
Founder, Eastern Insurance Holdings, Inc.

Ira H. Fuchs
President, BITNET, LLC

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Chancellor, Rutgers University — Camden

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President & CEO, Empire Abrasive
Equipment Company
President & CEO, Delaware Car Company

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Contributionship
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Vice President, CFO and Treasurer
Stephen A. McGowan,
Assistant Vice President, Controller and
Assistant Treasurer
Stacey M. Manzo,
Assistant Vice President, Secretary

ANNUAL MEETING

The 267th Annual meeting of the Members
of the Company will be held on Monday,
April 29, 2019, at 11:00 a.m. at the
Company's office.



The Philadelphia Contributionship

DEPENDABLE INSURANCE PARTNERS SINCE 1752

The Philadelphia Contributionship
212 South Fourth Street
Philadelphia, Pa 19106-9232

215.627.1752 888.627.1752 www.1752.com