

KINGSWAY FINANCIAL SERVICES INC  
Form 10-Q  
August 08, 2013  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

June 30, 2013

or  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2013

Commission File Number: 001-15204

Kingsway Financial Services Inc.  
(Exact name of registrant as specified in its charter)

Ontario, Canada  
(State or other jurisdiction of  
incorporation or organization)  
45 St. Clair Avenue West, Suite 400 Toronto, Ontario M4V 1K9  
(Address of principal executive offices and zip code)  
1-416-848-1171  
(Registrant's telephone number, including area code)

Not Applicable (I.R.S. Employer  
Identification No.)

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer   
(Do not check if a smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
The number of shares outstanding of the registrant's common stock as of August 8, 2013 was 13,148,971.



KINGSWAY FINANCIAL SERVICES INC.

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## KINGSWAY FINANCIAL SERVICES INC.

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Consolidated Balance Sheets

(in thousands, except per share data)

|  | June 30, 2013<br>(unaudited) | December 31,<br>2012 |
|--|------------------------------|----------------------|
| <b>ASSETS</b>  |                              |                      |
| Investments:   |                              |                      |
| Fixed maturities, at fair value (amortized cost of \$71,254 and \$77,858, respectively)          | \$72,256                     | \$79,534             |
| Equity investments, at fair value (cost of \$27,775 and \$2,305, respectively)                   | 31,110                       | 3,548                |
| Limited liability investments  | 2,268                        | 2,333                |
| Other investments, at cost which approximates fair value   | 3,031                        | 2,000                |
| Short-term investments, at cost which approximates fair value                                    | 586                          | 585                  |
| Total investments  | 109,251                      | 88,000               |
| Cash and cash equivalents  | 71,351                       | 80,813               |
| Investment in investee   | —                            | 41,733               |
| Accrued investment income  | 635                          | 2,263                |
| Premiums receivable, net of allowance for doubtful accounts of \$3,977 and \$4,040, respectively | 34,864                       | 35,598               |
| Service fee receivable   | 19,313                       | 15,173               |
| Other receivables, net of allowance for doubtful accounts of \$1,002 and \$1,002, respectively   | 4,852                        | 4,750                |
| Reinsurance recoverable  | 15,133                       | 8,557                |
| Prepaid reinsurance premiums   | 11,835                       | 7,316                |
| Deferred acquisition costs, net  | 11,797                       | 14,102               |
| Property and equipment, net of accumulated depreciation of \$23,707 and \$22,887, respectively   | 2,159                        | 2,709                |
| Goodwill   | 9,484                        | 8,421                |
| Intangible assets, net of amortization of \$20,329 and \$19,263, respectively                    | 50,569                       | 50,583               |
| Other assets   | 4,542                        | 4,045                |
| Asset held for sale  | 7,291                        | 8,737                |
| <b>TOTAL ASSETS</b>  | <b>\$353,076</b>             | <b>\$372,800</b>     |
| <b>LIABILITIES AND EQUITY</b>  |                              |                      |
| <b>LIABILITIES</b>   |                              |                      |
| Unpaid loss and loss adjustment expenses:  |                              |                      |
| Property and casualty  | \$96,703                     | \$103,116            |
| Vehicle service agreements   | 3,140                        | 3,448                |
| Total unpaid loss and loss adjustment expenses   | 99,843                       | 106,564              |
| Unearned premiums  | 47,308                       | 45,047               |
| Reinsurance payable  | 7,620                        | 4,956                |
| LROC preferred units   | 14,204                       | 13,655               |
| Senior unsecured debentures  | 26,356                       | 23,730               |
| Subordinated debt  | 26,674                       | 23,774               |
| Deferred income tax liability  | 3,602                        | 3,054                |

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|   |                  |                  |
|---|------------------|------------------|
| Deferred service fees   | 49,198           | 48,987           |
| Income taxes payable  | 2,821            | 2,879            |
| Accrued expenses and other liabilities  | 34,533           | 34,740           |
| <b>TOTAL LIABILITIES</b>  | <b>\$312,159</b> | <b>\$307,386</b> |
| <b>EQUITY</b>   |                  |                  |
| Common stock, no par value; unlimited number authorized; 13,148,971 issued and outstanding at June 30, 2013 and December 31, 2012 | \$296,621        | \$296,621        |
| Additional paid-in capital  | 15,824           | 15,757           |
| Accumulated deficit   | (289,784         | ) (262,069       |
| Accumulated other comprehensive income  | 16,862           | 14,762           |
| Shareholders' equity attributable to common shareholders  | 39,523           | 65,071           |
| Noncontrolling interests in consolidated subsidiaries   | 1,394            | 343              |
| <b>TOTAL EQUITY</b>   | <b>40,917</b>    | <b>65,414</b>    |
| <b>TOTAL LIABILITIES AND EQUITY</b>   | <b>\$353,076</b> | <b>\$372,800</b> |
| See accompanying notes to unaudited consolidated financial statements.  |                  |                  |

## KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Operations  
(in thousands, except per share data)  
(Unaudited)

|  | Three months ended June 30, |                   | Six months ended June 30, |                    |
|--|-----------------------------|-------------------|---------------------------|--------------------|
|  | 2013                        | 2012              | 2013                      | 2012               |
| <b>Revenue:</b>  |                             |                   |                           |                    |
| Net premiums earned  | \$28,297                    | \$30,985          | \$56,365                  | \$60,252           |
| Service fee and commission income  | 12,052                      | 8,138             | 25,176                    | 17,667             |
| Net investment income  | 816                         | 797               | 1,396                     | 1,623              |
| Net realized gains (losses)  | 32                          | (23 )             | (1,377 )                  | 250                |
| Other-than-temporary impairment loss   | (1,800 )                    | (488 )            | (1,800 )                  | (488 )             |
| Gain (loss) on change in fair value of debt  | 2,338                       | (2,418 )          | (6,613 )                  | (6,749 )           |
| Other income   | 2,174                       | 2,744             | 4,392                     | 3,827              |
| <b>Total revenues</b>  | <b>43,909</b>               | <b>39,735</b>     | <b>77,539</b>             | <b>76,382</b>      |
| <b>Expenses:</b>   |                             |                   |                           |                    |
| Loss and loss adjustment expenses  | 24,615                      | 23,616            | 46,446                    | 45,391             |
| Commissions and premium taxes  | 5,171                       | 4,747             | 11,883                    | 9,166              |
| General and administrative expenses  | 20,289                      | 17,154            | 40,048                    | 35,955             |
| Restructuring expense  | 147                         | —                 | 927                       | —                  |
| Interest expense   | 1,927                       | 1,916             | 3,760                     | 3,765              |
| Amortization of intangible assets  | 508                         | —                 | 1,066                     | —                  |
| Impairment of asset held for sale  | 1,446                       | —                 | 1,446                     | —                  |
| <b>Total expenses</b>  | <b>54,103</b>               | <b>47,433</b>     | <b>105,576</b>            | <b>94,277</b>      |
| Loss before loss on buy-back of debt, equity in net income (loss) of investee and income tax (benefit) expense | (10,194 )                   | (7,698 )          | (28,037 )                 | (17,895 )          |
| Loss on buy-back of debt   | —                           | —                 | (24 )                     | —                  |
| Equity in net income (loss) of investee  | —                           | 97                | 255                       | (2,169 )           |
| Loss before income tax (benefit) expense   | (10,194 )                   | (7,601 )          | (27,806 )                 | (20,064 )          |
| Income tax (benefit) expense   | (525 )                      | 116               | (801 )                    | 175                |
| <b>Net loss</b>  | <b>(9,669 )</b>             | <b>(7,717 )</b>   | <b>(27,005 )</b>          | <b>(20,239 )</b>   |
| Less: net income (loss) attributable to noncontrolling interests in consolidated subsidiaries                  | 617                         | (1,700 )          | 712                       | (3,214 )           |
| <b>Net loss attributable to common shareholders</b>  | <b>\$(10,286 )</b>          | <b>\$(6,017 )</b> | <b>\$(27,717 )</b>        | <b>\$(17,025 )</b> |
| <b>Loss per share – net loss:</b>  |                             |                   |                           |                    |
| Basic:   | \$(0.74 )                   | \$(0.59 )         | \$(2.05 )                 | \$(1.54 )          |
| Diluted:   | (0.74 )                     | (0.59 )           | (2.05 )                   | (1.54 )            |
| <b>Weighted average shares outstanding (in '000s):</b>   |                             |                   |                           |                    |
| Basic:   | 13,149                      | 13,149            | 13,149                    | 13,117             |
| Diluted:   | 13,149                      | 13,149            | 13,149                    | 13,117             |

See accompanying notes to unaudited consolidated financial statements.



## KINGSWAY FINANCIAL SERVICES INC.

Consolidated Statements of Comprehensive Loss  
(in thousands)  
(unaudited)

|   | Three months ended June 30, |            | Six months ended June 30, |             |
|---|-----------------------------|------------|---------------------------|-------------|
|   | 2013                        | 2012       | 2013                      | 2012        |
| Net loss  | \$(9,669 )                  | \$(7,717 ) | \$(27,005 )               | \$(20,239 ) |
| Other comprehensive income (loss), net of taxes <sup>(1)</sup> :  |                             |            |                           |             |
| Unrealized gains (losses) on fixed maturities and equity investments:                                   |                             |            |                           |             |
| Unrealized gains arising during the period  | 1,639                       | 417        | 1,136                     | 197         |
| Reclassification adjustment for losses (gains) included in net loss                                     | 34                          | (509 )     | 282                       | (367 )      |
| Foreign currency translation adjustments  | (2 )                        | (1,497 )   | (1 )                      | 27          |
| Equity in other comprehensive income of investee  | 747                         | 28         | 642                       | 339         |
| Other comprehensive income (loss)   | 2,418                       | (1,561 )   | 2,059                     | 196         |
| Comprehensive loss  | (7,251 )                    | (9,278 )   | (24,946 )                 | (20,043 )   |
| Less: comprehensive income (loss) attributable to noncontrolling interests in consolidated subsidiaries | 605                         | (1,722 )   | 671                       | (3,318 )    |
| Comprehensive loss attributable to common shareholders  | \$(7,856 )                  | \$(7,556 ) | \$(25,617 )               | \$(16,725 ) |

(1) Net of income tax (benefit) expense of \$0 and \$0 for the three and six months ended June 30, 2013 and June 30, 2012, respectively.

See accompanying notes to unaudited consolidated financial statements



## KINGSWAY FINANCIAL SERVICES INC.

## Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

|   | Six months ended June 30, |             |
|---|---------------------------|-------------|
|   | 2013                      | 2012        |
| Cash provided by (used in):   |                           |             |
| Operating activities:   |                           |             |
| Net loss  | \$(27,005                 | ) \$(20,239 |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |             |
| Equity in net (income) loss of investee                                     | (255                      | ) 2,169     |
| Equity in net (income) loss of limited liability investments                | (155                      | ) 9         |
| Depreciation and amortization   | 1,885                     | 1,063       |
| Stock based compensation expense, net of forfeitures                        | 67                        | 101         |
| Net realized losses (gains)   | 1,377                     | (250        |
| Loss on change in fair value of debt  | 6,613                     | 6,749       |
| Deferred income taxes   | (136                      | ) —         |
| Other than temporary impairment loss  | 1,800                     | 488         |
| Amortization of fixed maturities premiums and discounts                     | 1,906                     | 1,574       |
| Impairment of asset held for sale   | 1,446                     | —           |
| Realized loss on buy-back of debt   | 24                        | —           |
| Changes in operating assets and liabilities:                                |                           |             |
| Premiums and service fee receivable   | (3,406                    | ) (4,681    |
| Reinsurance recoverable   | (6,576                    | ) (4,988    |
| Deferred acquisition costs  | 2,305                     | 482         |
| Income taxes recoverable  | —                         | 1,002       |
| Unpaid loss and loss adjustment expenses                                    | (6,721                    | ) (20,608   |
| Unearned premiums   | 2,261                     | 2,483       |
| Reinsurance payable   | 2,664                     | 2,463       |
| Deferred service fees   | 211                       | 2,080       |
| Other, net  | (3,897                    | ) (834      |
| Net cash used in operating activities                                       | (25,592                   | ) (30,937   |
| Investing activities:   |                           |             |
| Proceeds from sales and maturities of fixed maturities                      | 10,878                    | 51,145      |
| Proceeds from sales of equity investments                                   | 377                       | —           |
| Proceeds from sales of investment in investee                               | 13,638                    | —           |
| Purchase of fixed maturities  | (4,892                    | ) (42,223   |
| Purchase of equity investments  | (23                       | ) —         |
| Net acquisition of limited liability investments                            | (588                      | ) —         |
| Purchase of other investments   | (1,031                    | ) —         |
| Net purchases of short-term investments                                     | (325                      | ) —         |
| Acquisition of business, net of cash acquired                               | (1,052                    | ) —         |
| Net purchases of property and equipment and intangible assets               | (269                      | ) (502      |
| Net cash provided by investing activities                                   | 16,713                    | 8,420       |
| Financing activities:   |                           |             |
| Common stock issued   | —                         | 132         |
| Redemption of senior unsecured debentures                                   | (583                      | ) —         |
| Net cash (used in) provided by financing activities                         | (583                      | ) 132       |
| Net decrease in cash and cash equivalents                                   | (9,462                    | ) (22,385   |

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|  |          |          |
|--|----------|----------|
| Cash and cash equivalents at beginning of period                       | 80,813   | 85,486   |
| Cash and cash equivalents at end of period                             | \$71,351 | \$63,101 |
| See accompanying notes to unaudited consolidated financial statements. |          |          |

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

NOTE 1 BUSINESS

Kingsway Financial Services Inc. (the "Company" or "Kingsway") was incorporated under the Business Corporations Act (Ontario) on September 19, 1989. Kingsway is a holding company and is primarily engaged, through its subsidiaries, in the property and casualty insurance business.

NOTE 2 BASIS OF PRESENTATION

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements of the Company. In the opinion of management, all adjustments necessary for a fair presentation have been included and are of a normal recurring nature. Interim results are not necessarily indicative of the results that may be expected for the year. The accompanying unaudited consolidated interim financial statements and footnotes should be read in conjunction with the audited consolidated financial statements and footnotes included within our Annual Report on Form 10-K ("2012 Annual Report") for the year ended December 31, 2012.

The unaudited consolidated interim financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions and balances have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying unaudited consolidated interim financial statements include the provision for unpaid loss and loss adjustment expenses, valuation of fixed maturities and equity investments, valuation of deferred income taxes, valuation of intangible assets, goodwill recoverability, deferred acquisition costs, and fair value assumptions for debt obligations. The fair values of the Company's investments in fixed maturities and equity investments, LROC preferred units, senior unsecured debentures and subordinated debt are estimated using a fair value hierarchy to categorize the inputs it uses in valuation techniques. Fair values for other investments approximate their unpaid principal balances. The carrying amounts reported in the consolidated balance sheets approximate fair values for cash, short-term investments and certain other assets and other liabilities because of their short-term nature.

The Company's financial results contained herein are reported in U.S. dollars unless otherwise indicated.

NOTE 3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no material changes to our significant accounting policies as reported in our 2012 Annual Report.

NOTE 4 RECENTLY ISSUED ACCOUNTING STANDARDS

Adoption of New Accounting Standards:

In July 2012, the FASB issued ASU 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02"). ASU 2012-02 provides entities with an option to first assess qualitative factors to determine whether events or circumstances indicate that it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity concludes that it is more than 50% likely that an indefinite-lived intangible asset is not impaired, no further analysis is required. However, if an entity concludes otherwise, it would be required to determine the fair value of the indefinite-lived intangible asset to measure the amount of actual impairment, if any, as currently required under US GAAP. Effective January 1, 2013, the Company adopted ASU 2012-02 and the adoption did not have an impact on the consolidated financial statements. There have been no triggering events that would suggest possible impairment or that it is more-likely-than-not that the fair values of indefinite-lived intangible assets are less than their carrying amounts. The Company will utilize the new guidance

during its annual impairment testing in December 2013.

In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"), which is intended to improve the reporting of reclassifications out of accumulated other comprehensive

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

income. The ASU requires an entity to report, either on the face of the income statement or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the income statement if the amount being reclassified is required to be reclassified in its entirety to net income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other required disclosures that provide additional detail about those amounts. Effective January 1, 2013, the Company adopted ASU 2013-02. Except for the new disclosure requirements, the adoption of the standard did not have an impact on the consolidated financial statements. The required disclosures are included in Note 16, "Accumulated Other Comprehensive Income."

In July 2013, the FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ("ASU 2013-11"). ASU 2013-11 is effective for the first interim or annual period beginning on or after December 15, 2013 with early adoption permitted. ASU 2013-11 amends ASC Topic 740, Income Taxes, to provide guidance and reduce diversity in practice on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Except for the changes, if any, in the Company's presentation, the initial application of the standard will not impact the Company.

NOTE 5 ACQUISITIONS

(a) IWS Acquisition Corporation:

Effective November 16, 2012, the Company's subsidiary, IWS Acquisition Corporation ("IWS"), acquired certain tangible and intangible assets and liabilities of Intercontinental Warranty Services, Inc. for total consideration consisting of approximately \$4.9 million in cash, future contingent payments and common equity in a newly formed entity.

IWS is based in Florida and is a provider of after-market vehicle protection services distributed by credit unions throughout the United States and Puerto Rico to their members. The acquisition allows the Company to benefit from the institutional knowledge of the credit unions' vehicle loan programs and expand into the vehicle protection service business.

This acquisition was accounted for as a business combination using the purchase method of accounting. The purchase price was allocated to the assets purchased and liabilities assumed based upon their estimated fair values at the date of acquisition. During the fourth quarter of 2012, the Company began its fair value analysis on the assets acquired and liabilities assumed. In accordance with U.S. GAAP, fair value accounting effects may be adjusted up to one year from the acquisition date upon finalization of the valuation process. The Company recorded adjustments related to the acquisition during the first six months of 2013, which resulted in an increase to goodwill of \$1.1 million from the amount recorded at December 31, 2012.

After allocation of additional purchase price, goodwill of \$9.0 million was recognized in addition to \$12.4 million of separately identifiable intangible assets. Of this amount, \$8.7 million of separately identifiable intangible assets related to this acquisition resulted from the valuations of acquired database, customer-related relationships, trade name and non-compete agreement. An additional \$3.7 million of separately identifiable intangible assets resulted from the valuation of vehicle service agreements in-force ("VSA in-force"). Refer to Note 10, "Intangible Assets," for further disclosure on intangible assets related to this acquisition. The fair value analysis performed included \$3.9 million related to present value of future contingent payments. The maximum the Company can pay in future contingent payments is \$11.1 million, on an undiscounted basis. The contingent payments are payable annually beginning in 2013 through 2018 and are subject to the achievement of certain targets and may be adjusted in future periods based on actual performance achieved. As of June 30, 2013, the recorded value of the contingent earn-out agreement is \$4.3 million, which is included in accrued expenses and other liabilities on the consolidated balance sheets.

(b) Trinity Warranty Solutions LLC:

Effective May 22, 2013, the Company's subsidiary, Trinity Warranty Solutions LLC ("TWS"), acquired certain intangible assets of Trinity Warranty Corp. for total consideration consisting of approximately \$1.1 million in cash and future contingent payments. The consolidated statements of operations include the earnings of TWS from the date of acquisition. As further discussed in Note 17, "Segmented Information," TWS is included in the Insurance Services segment. TWS is based in Illinois and is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning and refrigeration industry.

This acquisition will be accounted for as a business combination using the purchase method of accounting. The purchase price is expected to be allocated during the third quarter of 2013 to the assets purchased based upon their estimated fair values at the date of acquisition. Refer to Note 10, "Intangible Assets," for further disclosure on intangible assets related to this acquisition.

KINGSWAY FINANCIAL SERVICES INC.  
Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

## NOTE 6 INVESTMENTS

The amortized cost, gross unrealized gains and losses, and estimated fair value of the Company's investments in fixed maturities and equity investments at June 30, 2013 and December 31, 2012 are summarized in the tables shown below:

| (in thousands)  | June 30, 2013  |                        |                         |                      |
|---|----------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities:   |                |                        |                         |                      |
| U.S. government, government agencies and authorities            | \$26,015       | \$749                  | \$13                    | \$26,751             |
| Canadian government   | 4,283          | —                      | 101                     | 4,182                |
| States municipalities and political subdivisions                | 7,142          | 134                    | 1                       | 7,275                |
| Mortgage-backed   | 282            | 16                     | —                       | 298                  |
| Asset-backed securities and collateralized mortgage obligations | 156            | 2                      | —                       | 158                  |
| Corporate   | 33,376         | 228                    | 12                      | 33,592               |
| Total fixed maturities  | 71,254         | 1,129                  | 127                     | 72,256               |
| Equity investments:   |                |                        |                         |                      |
| Common stock  | 11,575         | 3,356                  | 21                      | 14,910               |
| Preferred stock   | 16,200         | —                      | —                       | 16,200               |
| Total equity investments  | 27,775         | 3,356                  | 21                      | 31,110               |
| Total fixed maturities and equity investments                   | \$99,029       | \$4,485                | \$148                   | \$103,366            |

| (in thousands)  | December 31, 2012 |                        |                         |                      |
|---|-------------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Fixed maturities:   |                   |                        |                         |                      |
| U.S. government, government agencies and authorities            | \$23,954          | \$962                  | \$1                     | \$24,915             |
| Canadian government   | 3,822             | —                      | 40                      | 3,782                |
| States municipalities and political subdivisions                | 7,158             | 187                    | —                       | 7,345                |
| Mortgage-backed   | 4,850             | 193                    | —                       | 5,043                |
| Asset-backed securities and collateralized mortgage obligations | 1,084             | 8                      | —                       | 1,092                |
| Corporate   | 36,990            | 391                    | 24                      | 37,357               |
| Total fixed maturities  | 77,858            | 1,741                  | 65                      | 79,534               |
| Equity investments:   |                   |                        |                         |                      |
| Common stock  | 2,305             | 1,256                  | 13                      | 3,548                |
| Total fixed maturities and equity investments                   | \$80,163          | \$2,997                | \$78                    | \$83,082             |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

Amortized cost, gross unrealized gains and estimated fair value for common stock in the preceding table at June 30, 2013 include \$9.3 million, \$2.0 million and \$11.3 million, respectively, for the Company's investment in the common stock of the Company's former investee, Atlas Financial Holdings, Inc. ("Atlas"). As discussed further in Note 7, Investment in Investee, the Company's investment in the common stock of Atlas was accounted for under the equity method of accounting and reported as investment in investee in the consolidated balance sheets at December 31, 2012.

Amortized cost and estimated fair value for preferred stock in the preceding table at June 30, 2013 include \$16.2 million and \$16.2 million, respectively, for the Company's investment in the preferred stock of Atlas. The Company's investment in the preferred stock of Atlas was reported as investment in investee in the consolidated balance sheets at December 31, 2012.

The table below summarizes the Company's fixed maturities at June 30, 2013 by contractual maturity periods. Actual results may differ as issuers may have the right to call or prepay obligations, with or without penalties, prior to the contractual maturity of these obligations.

| (in thousands)                         | June 30, 2013  |                      |
|--|----------------|----------------------|
|  | Amortized Cost | Estimated Fair Value |
| Due in one year or less                | \$25,289       | \$25,380             |
| Due after one year through five years  | 44,587         | 45,392               |
| Due after five years through ten years | 1,130          | 1,221                |
| Due after ten years                    | 248            | 263                  |
| Total                                  | \$71,254       | \$72,256             |

The following tables highlight the aggregate unrealized loss position, by security type, of fixed maturities and equity investments in unrealized loss positions as of June 30, 2013 and December 31, 2012. The tables segregate the holdings based on the period of time the investments have been continuously held in unrealized loss positions.

| (in thousands)                                       | June 30, 2013        |                 |                        |                 |                      |                 |
|--|----------------------|-----------------|------------------------|-----------------|----------------------|-----------------|
|  | Less than 12 Months  |                 | Greater than 12 Months |                 | Total                |                 |
|  | Estimated Fair Value | Unrealized Loss | Estimated Fair Value   | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Fixed maturities:                                    |                      |                 |                        |                 |                      |                 |
| U.S. government, government agencies and authorities | \$4,848              | \$13            | \$—                    | \$—             | \$4,848              | \$13            |
| Canadian government                                  | 4,182                | 101             | —                      | —               | 4,182                | 101             |
| States municipalities and political subdivisions     | 1,002                | 1               | —                      | —               | 1,002                | 1               |
| Mortgage-backed                                      | 127                  | —               | —                      | —               | 127                  | —               |
| Corporate  | 1,031                | 10              | 1,008                  | 2               | 2,039                | 12              |
| Total fixed maturities                               | 11,190               | 125             | 1,008                  | 2               | 12,198               | 127             |
| Equity investments:                                  |                      |                 |                        |                 |                      |                 |
| Common stock   | 154                  | 21              | —                      | —               | 154                  | 21              |
| Total  | \$11,344             | \$146           | \$1,008                | \$2             | \$12,352             | \$148           |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

| (in thousands)                                       | Less than 12 Months  |                 | Greater than 12 Months |                 | December 31, 2012    |                 |
|--|----------------------|-----------------|------------------------|-----------------|----------------------|-----------------|
|  | Estimated Fair Value | Unrealized Loss | Estimated Fair Value   | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Fixed maturities:                                    |                      |                 |                        |                 |                      |                 |
| U.S. government, government agencies and authorities | \$4,612              | \$1             | \$—                    | \$—             | \$4,612              | \$1             |
| Canadian government                                  | 3,782                | 40              | —                      | —               | 3,782                | 40              |
| Mortgage-backed                                      | —                    | —               | 267                    | —               | 267                  | —               |
| Corporate  | 4,169                | 14              | —                      | 10              | 4,169                | 24              |
| Total fixed maturities                               | 12,563               | 55              | 267                    | 10              | 12,830               | 65              |
| Equity investments:                                  |                      |                 |                        |                 |                      |                 |
| Common stock   | 8                    | 1               | 38                     | 12              | 46                   | 13              |
| Total  | \$12,571             | \$56            | \$305                  | \$22            | \$12,876             | \$78            |

Fixed maturities and equity investments contain approximately 17 and 19 individual investments that were in unrealized loss positions as of June 30, 2013 and December 31, 2012, respectively.

The establishment of an other-than-temporary impairment on an investment requires a number of judgments and estimates. The Company performs a quarterly analysis of the individual investments to determine if declines in market value are other-than-temporary. The analysis includes some or all of the following procedures as deemed appropriate by the Company:

- identifying all unrealized loss positions that have existed for at least six months;
- identifying other circumstances which management believes may impact the recoverability of the unrealized loss positions;
- obtaining a valuation analysis from third-party investment managers regarding the intrinsic value of these investments based on their knowledge and experience together with market-based valuation techniques;
- reviewing the trading range of certain investments over the preceding calendar period;
- assessing if declines in market value are other-than-temporary for debt instruments based on the investment grade credit ratings from third-party rating agencies;
- assessing if declines in market value are other-than-temporary for any debt instrument with a non-investment grade credit rating based on the continuity of its debt service record;
- determining the necessary provision for declines in market value that are considered other-than-temporary based on the analyses performed; and
- assessing the Company's ability and intent to hold these investments at least until the investment impairment is recovered.

The risks and uncertainties inherent in the assessment methodology used to determine declines in market value that are other-than-temporary include, but may not be limited to, the following:

- the opinions of professional investment managers could be incorrect;
- the past trading patterns of individual investments may not reflect future valuation trends;
- the credit ratings assigned by independent credit rating agencies may be incorrect due to unforeseen or unknown facts related to a company's financial situation; and
- the debt service pattern of non-investment grade instruments may not reflect future debt service capabilities and may not reflect a company's unknown underlying financial problems.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, a write-down for other-than-temporary impairment related to other investments of zero and \$0.5 million was recorded for the three months ended June 30, 2013 and June 30, 2012, respectively (zero and \$0.5 million for the six months ended June 30, 2013 and June 30, 2012, respectively).

On July 8, 2013, the Company announced that it had entered into a non-binding letter of intent with Atlas to sell its holdings of Atlas preferred stock for 90.0% of liquidation value, or \$16.2 million. On August 1, 2013, the Company

announced that the transaction had closed. As a result, the Company recorded a write-down for other-than-temporary impairment related to its investment in Atlas preferred stock of \$1.8 million for the three months ended June 30, 2013.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

There were no write-downs related to fixed maturities for other-than-temporary impairments for the three and six months ended June 30, 2013 and June 30, 2012. There were no other-than-temporary losses recognized in other comprehensive income (loss) for the three and six months ended June 30, 2013 and June 30, 2012.

The Company has reviewed currently available information regarding investments with estimated fair values that are less than their carrying amounts and believes that these unrealized losses are not other-than-temporary and are primarily due to temporary market and sector-related factors rather than to issuer-specific factors. The Company does not intend to sell those investments, and it is not likely that it will be required to sell those investments before recovery of its amortized cost.

The Company does not have any exposure to subprime mortgage-backed investments.

Limited liability investments include investments in limited liability companies and a limited partnership that primarily invest in income-producing real estate. The Company's interests in these investments are not deemed minor and, therefore, are accounted for under the equity method of accounting. As of June 30, 2013 and December 31, 2012, the carrying value of limited liability investments totaled \$2.3 million and \$2.3 million, respectively. At June 30, 2013, the Company has unfunded commitments totaling \$4.0 million to fund limited liability investments. Income from limited liability investments is recognized based on the Company's share of the earnings of the limited liability entities and is included in net investment income.

Other investments include collateral and mortgage loans and are reported at their unpaid principal balance. As of June 30, 2013 and December 31, 2012, the carrying value of other investments totaled \$3.0 million and \$2.0 million, respectively.

Gross realized gains and losses on fixed maturities, equity investments and limited liability investments for the three and six months ended June 30, 2013 and June 30, 2012 were as follows:

| (in thousands)        | Three months ended June 30, |         | Six months ended June 30, |       |
|-----------------------|-----------------------------|---------|---------------------------|-------|
|                       | 2013                        | 2012    | 2013                      | 2012  |
| Gross realized gains  | \$64                        | \$51    | \$373                     | \$324 |
| Gross realized losses | (32 )                       | (74 )   | (32 )                     | (74 ) |
| Total                 | \$32                        | \$(23 ) | \$341                     | \$250 |

Gross realized losses for the six months ended June 30, 2013 reported in the preceding table excludes the realized loss on sale of Atlas common stock recorded during the first quarter of 2013. Refer to Note 7, Investment in Investee, for further discussion.

Net investment income for the three and six months ended June 30, 2013 and June 30, 2012, respectively, is comprised as follows:

| (in thousands)                                   | Three months ended June 30, |        | Six months ended June 30, |         |
|--|-----------------------------|--------|---------------------------|---------|
|  | 2013                        | 2012   | 2013                      | 2012    |
| Investment income                                |                             |        |                           |         |
| Interest from fixed maturities                   | \$368                       | \$600  | \$650                     | \$1,118 |
| Dividends  | 237                         | 262    | 490                       | 504     |
| Income (loss) from limited liability investments | 105                         | (5 )   | 155                       | (9 )    |
| Other  | 167                         | 63     | 259                       | 229     |
| Gross investment income                          | 877                         | 920    | 1,554                     | 1,842   |
| Investment expenses                              | (61 )                       | (123 ) | (158 )                    | (219 )  |
| Net investment income                            | \$816                       | \$797  | \$1,396                   | \$1,623 |

At June 30, 2013, fixed maturities and short-term investments with an estimated fair value of \$14.4 million were on deposit with state and provincial regulatory authorities. Also, from time to time, the Company pledges investments to third-parties to collateralize liabilities incurred under its policies of insurance. At June 30, 2013, the amount of such pledged securities was \$24.5 million.



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

## NOTE 7 INVESTMENT IN INVESTEE

Investment in investee includes the Company's investment in the preferred and restricted voting common stock of Atlas. On February 12, 2013, the Company executed an underwriting agreement to sell 2,625,000 shares of Atlas common stock. The shares were being offered as part of Atlas' United States initial public offering at a price per share of \$5.85. During the first quarter of 2013, the Company received net proceeds of \$13.6 million and recognized a loss of \$1.7 million, which is included in net realized losses on the consolidated statements of operations, resulting from commissions and other expenses incurred as part of the sale. As a result of this sale, the Company's approximate voting percentage in Atlas was reduced to 16.5%. As a result of this change in ownership and other qualitative factors, the Company determined that its investment in the common stock of Atlas no longer qualified for the equity method of accounting. Accordingly, the Company's investments in Atlas common stock and preferred stock are included in equity investments and reported at their fair values of \$11.3 million and \$16.2 million, respectively, in the consolidated balance sheets at June 30, 2013. The Company's share of its investee's equity adjustments for other comprehensive income of \$0.7 million was offset against the carrying value of the Company's investment in Atlas common stock during the second quarter of 2013. Prior to discontinuing the use of the equity method of accounting for Atlas, the Company used a reporting lag of three months to report its proportionate share of Atlas' results. The carrying value, estimated fair value and approximate voting and equity percentages for the Company's investment in the common stock of Atlas, which was accounted for under the equity method of accounting and reported as investment in investee in the Company's consolidated balance sheets at December 31, 2012, were as follows: (in thousands, except for percentages)

|       | December 31, 2012 |                   |                      |                |
|-------|-------------------|-------------------|----------------------|----------------|
|       | Voting percentage | Equity percentage | Estimated Fair Value | Carrying value |
| Atlas | 30.0              | % 63.3            | % \$38,758           | \$41,733       |

The fair value of the Company's investment in Atlas at December 31, 2012 in the table above is calculated based on the published closing price of Atlas at September 30, 2012 to be consistent with the three-month lag in reporting its carrying value under the equity method.

Equity in net income (loss) of investee was income of zero and \$0.1 million for the three months ended June 30, 2013 and June 30, 2012, respectively (income of \$0.3 million and loss of \$2.2 million, respectively, year to date). The Company also recognized an increase to shareholders' equity attributable to common shareholders of \$0.7 million and \$0.6 million for the three and six months ended June 30, 2013, respectively, for the Company's pro rata share of its investee's accumulated other comprehensive income.

## NOTE 8 DEFERRED ACQUISITION COSTS

Policy acquisition costs consist primarily of commissions, premium taxes, and underwriting and agency expenses incurred related to successful efforts to acquire new or renewal insurance contracts, net of ceding commission income, and vehicle service agreements. Acquisition costs deferred on both property and casualty insurance products and vehicle service agreements are amortized over the period in which the related revenues are earned.

The components of deferred acquisition costs and the related amortization expense for the three and six months ended June 30, 2013 and 2012, respectively, is comprised as follows:

| (in thousands)          | Three months ended June 30, |         | Six months ended June 30, |         |
|-------------------------|-----------------------------|---------|---------------------------|---------|
|                         | 2013                        | 2012    | 2013                      | 2012    |
| Beginning balance, net  | \$12,685                    | \$8,403 | \$14,102                  | \$8,116 |
| Additions               | 6,595                       | 2,649   | 15,767                    | 8,858   |
| Amortization            | (7,483)                     | (3,418) | (18,072)                  | (9,340) |
| Balance at June 30, net | \$11,797                    | \$7,634 | \$11,797                  | \$7,634 |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

## NOTE 9 GOODWILL

Goodwill was \$9.5 million and \$8.4 million at June 30, 2013 and December 31, 2012, respectively. As further discussed in Note 5, "Acquisitions," during the first six months of 2013, the Company continued its evaluation of certain tangible and intangible assets and liabilities of Intercontinental Warranty Services, Inc. that were acquired on November 16, 2012, which resulted in an increase to goodwill of \$1.1 million from the amount recorded at December 31, 2012.

## NOTE 10 INTANGIBLE ASSETS

Intangible assets are comprised as follows:  
(in thousands)

|   | June 30, 2013 | December 31, 2012 |
|---|---------------|-------------------|
| Intangible assets subject to amortization     |               |                   |
| Database                                      | \$4,611       | \$4,907           |
| VSA in-force                                  | 2,116         | 2,770             |
| Customer-related relationships                | 4,004         | 3,056             |
| Non-compete agreement                         | 54            | 66                |
| Intangible assets not subject to amortization |               |                   |
| Insurance licenses                            | 7,803         | 7,803             |
| Renewal rights                                | 31,318        | 31,318            |
| Trade name                                    | 663           | 663               |
| Intangible assets                             | \$50,569      | \$50,583          |

As further discussed in Note 5, "Acquisitions," during the second quarter of 2013, the Company acquired certain intangible assets of Trinity Warranty Corp. for total consideration consisting of approximately \$1.1 million in cash and future contingent payments. The purchase price is expected to be allocated to the intangible assets purchased based upon their estimated fair values at the date of acquisition during the third quarter of 2013. Accordingly, the customer-related relationships intangible asset in the preceding table includes \$1.1 million related to the estimated TWS intangible asset acquired.

The Company's intangible assets with indefinite useful lives are not amortized. The Company's intangible assets with definite useful lives are amortized over their estimated useful lives. Accumulated amortization for these intangibles as of June 30, 2013 and December 31, 2012 was \$20.4 million and \$19.3 million, respectively. Amortization of intangible assets was \$0.5 million and zero for the three months ended June 30, 2013 and June 30, 2012, respectively (\$1.1 million and zero for the six months ended June 30, 2013 and June 30, 2012, respectively).

## NOTE 11 ASSET HELD FOR SALE

As of June 30, 2013, property consisting of building and land located in Miami, Florida with a carrying value of \$7.3 million was classified as held for sale. During the three months ended June 30, 2013, the Company recorded a write-down of \$1.4 million related to the asset held for sale. At June 30, 2013, the carrying value of the property is equal to its fair value net of estimated selling costs.

## NOTE 12 UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES

The establishment of the provision for unpaid loss and loss adjustment expenses is based on known facts and interpretation of circumstances and is therefore a complex and dynamic process influenced by a large variety of factors. These factors include the Company's experience with similar cases and historical trends involving loss payment patterns, pending levels of unpaid loss and loss adjustment expenses, product mix or concentration, loss severity and loss frequency patterns.

Other factors include the continually evolving and changing regulatory and legal environment; actuarial studies; professional experience and expertise of the Company's claims departments' personnel and independent adjusters retained to handle individual claims; the quality of the data used for projection purposes; existing claims management practices including claims-handling and settlement practices; the effect of inflationary trends on future loss settlement costs; court decisions; economic conditions; and public attitudes.

Consequently, the process of determining the provision necessarily involves risks that the actual results will deviate, perhaps materially, from the best estimates made.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

The Company's evaluation of the adequacy of unpaid loss and loss adjustment expenses includes a re-estimation of the liability for unpaid loss and loss adjustment expenses relating to each preceding financial year compared to the liability that was previously established.

## (a) Property and Casualty

The results of this comparison and the changes in the provision for property and casualty unpaid loss and loss adjustment expenses, net of amounts recoverable from reinsurers, as of June 30, 2013 and June 30, 2012 were as follows:

| (in thousands)   | June 30, 2013 | June 30, 2012 |
|--|---------------|---------------|
| Balance at beginning of period, gross  | \$ 103,116    | \$ 120,258    |
| Less reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses | 5,478         | 298           |
| Balance at beginning of period, net  | 97,638        | 119,960       |
| Incurred related to:   |               |               |
| Current year   | 43,992        | 45,064        |
| Prior years  | (834)         | 327           |
| Paid related to:   |               |               |
| Current year   | (20,116)      | (19,870)      |
| Prior years  | (31,897)      | (47,582)      |
| Balance at end of period, net  | 88,783        | 97,899        |
| Plus reinsurance recoverable related to property and casualty unpaid loss and loss adjustment expenses | 7,920         | 1,751         |
| Balance at end of period, gross  | \$96,703      | \$99,650      |

## (b) Vehicle Service Agreements

The results of the comparison and the changes in the provision for vehicle service agreement unpaid loss and loss adjustment expenses as of June 30, 2013 are presented below. The changes in and the provision for vehicle service agreement unpaid loss and loss adjustment expenses were zero as of June 30, 2012.

| (in thousands)                 | June 30, 2013 |
|--------------------------------|---------------|
| Balance at beginning of period | \$3,448       |
| Incurred related to:           |               |
| Current year                   | 3,288         |
| Prior years                    | —             |
| Paid related to:               |               |
| Current year                   | (3,515)       |
| Prior years                    | (81)          |
| Balance at end of period       | \$3,140       |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

## NOTE 13 DEBT

Debt consists of the following instruments:

| (in thousands)                | June 30, 2013 |            | December 31, 2012 |            |
|-------------------------------|---------------|------------|-------------------|------------|
|                               | Principal     | Fair Value | Principal         | Fair Value |
| 7.5% Senior notes due 2014    | \$26,356      | \$26,356   | \$26,966          | \$23,730   |
| LROC preferred units due 2015 | 15,020        | 14,204     | 15,879            | 13,655     |
| Subordinated debt             | 90,500        | 26,674     | 90,500            | 23,774     |
| Total                         | \$131,876     | \$67,234   | \$133,345         | \$61,159   |

Subordinated indebtedness mentioned above consists of the following trust preferred debt instruments:

| Issuer                          | Principal | Issue date | Interest  | Redemption date |
|---------------------------------|-----------|------------|---|-----------------|
| Kingsway CT Statutory Trust I   | 15,000    | 12/4/2002  | annual interest rate equal to LIBOR, plus 4.00% payable quarterly | 12/4/2032       |
| Kingsway CT Statutory Trust II  | 17,500    | 5/15/2003  | annual interest rate equal to LIBOR, plus 4.10% payable quarterly | 5/15/2033       |
| Kingsway CT Statutory Trust III | 20,000    | 10/29/2003 | annual interest rate equal to LIBOR, plus 3.95% payable quarterly | 10/29/2033      |
| Kingsway DE Statutory Trust III | 15,000    | 5/23/2003  | annual interest rate equal to LIBOR, plus 4.20% payable quarterly | 5/23/2033       |
| Kingsway DE Statutory Trust IV  | 10,000    | 9/30/2003  | annual interest rate equal to LIBOR, plus 3.85% payable quarterly | 9/30/2033       |
| Kingsway DE Statutory Trust VI  | 13,000    | 1/8/2004   | annual interest rate equal to LIBOR, plus 4.00% payable quarterly | 1/8/2034        |

During the first quarter of 2011, the Company gave notice to its Trust Preferred trustees of its intention to exercise its voluntary right to defer interest payments for up to 20 quarters, pursuant to the contractual terms of its outstanding Trust Preferred indentures, which permit interest deferral. This action does not constitute a default under the Company's Trust Preferred indentures or any of its other debt indentures. At June 30, 2013, deferred interest payable of \$10.5 million is included in accrued expenses and other liabilities in the consolidated balance sheets. The cash interest due in 2016 is subject to changes in the London interbank offered interest rate for three-month U.S. dollar deposits ("LIBOR") over the deferral period.

No debt repurchases were made during the second quarter of 2013. During the first quarter of 2013, the Company purchased for \$0.6 million, including accrued interest, \$0.6 million of par value of its senior unsecured debentures with a carrying value of \$0.6 million, including accrued interest, recording a loss of \$0.0 million. The Company subsequently canceled the acquired debentures. During the three and six months ended June 30, 2012, respectively, the Company did not buy-back any of its outstanding debt.

## NOTE 14 INCOME TAXES

Income tax benefit for the three and six months ended June 30, 2013 varies from the amount that would result by applying the applicable United States income tax rate of 34% to loss before income tax benefit primarily due to a valuation allowance being applied to the Company's operating losses, a tax expense being recorded attributable to the Company's indefinite life intangible assets and a tax benefit being recorded for a Canadian income tax refund. Income tax expense for the three and six months ended June 30, 2012 varies from the amount that would result by applying the applicable United States income tax rate of 34% to loss before income tax expense primarily due to a valuation allowance being applied to the Company's operating losses.

The Company maintains a valuation allowance for its gross deferred tax assets at June 30, 2013 and December 31, 2012. The Company's operations have generated substantial operating losses during the last several years. These losses can be available to reduce income taxes that might otherwise be incurred on future taxable income. The Company's operations, however, remain challenged and, as a result, it is uncertain whether the Company will generate

the taxable income necessary to utilize these losses or other reversing temporary differences. This uncertainty has caused management to place a full valuation allowance on its June 30, 2013 and December 31, 2012 net deferred tax asset. The Company carries a deferred tax liability of \$3.6 million and \$3.1 million at June 30, 2013 and December 31, 2012, respectively, all of which relates to indefinite life intangible assets.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

As of June 30, 2013 and December 31, 2012, the Company carried a liability for unrecognized tax benefits of \$3.0 million and \$3.0 million, respectively. The Company generally recognizes interest and penalties related to unrecognized tax benefits in income tax (benefit) expense.

## NOTE 15 NET LOSS PER SHARE

Net loss per share is based on the weighted-average number of shares outstanding. Diluted weighted-average shares is calculated by adjusting basic weighted-average shares outstanding by all potentially dilutive stock options. Since the Company is reporting a net loss for the three and six months ended June 30, 2013 and June 30, 2012, all stock options outstanding were excluded from the calculation of both basic and diluted loss per share since their inclusion would have been anti-dilutive.

On July 3, 2012, the Company announced that the Board of Directors of the Company authorized the implementation of a share consolidation at a ratio of one post-consolidation share for every four pre-consolidation shares. The share consolidation, which was approved by the stockholders at the Company's Annual and Special Meeting held on May 31, 2012, was effective as of July 3, 2012 (the "Effective Date"). As a result of the consolidation, every four of the Company's common shares that were issued and outstanding on the Effective Date were automatically combined into one issued and outstanding common share, without any change in the par value of such shares. Any fractional shares resulting from the consolidation were rounded up to the nearest whole. The consolidation had the effect of reducing the number of common shares of the Company issued and outstanding from 52,595,828 shares pre-consolidation to 13,148,971 shares post-consolidation. The issued and outstanding shares reported in the consolidated balance sheets and the number of weighted-average shares outstanding included in the loss per share computations, as reported in the consolidated statements of operations, have been restated for all periods presented to reflect the impact of the share consolidation.

## NOTE 16 ACCUMULATED OTHER COMPREHENSIVE INCOME

The table below details the components of accumulated other comprehensive income, net of tax, for the three and six months ended June 30, 2013 and June 30, 2012 as relates to shareholders' equity attributable to common shareholders on the consolidated balance sheets. On the other hand, the unaudited consolidated statements of comprehensive loss present the components of other comprehensive income (loss), net of tax, only for the three and six months ended June 30, 2013 and June 30, 2012 and inclusive of the components attributable to noncontrolling interests in consolidated subsidiaries.

|   | Three months ended June 30, |          | Six months ended June 30, |          |
|---|-----------------------------|----------|---------------------------|----------|
|   | 2013                        | 2012     | 2013                      | 2012     |
| Beginning balance   | \$14,433                    | \$14,588 | \$14,762                  | \$12,749 |
| Unrealized gains on fixed maturities and equity investments arising during the period | 1,650                       | 425      | 1,152                     | 304      |
| Reclassification adjustment for losses (gains) included in net loss                   | 34                          | (509)    | 282                       | (367)    |
| Foreign currency translation adjustments  | (2)                         | (1,485)  | 24                        | 22       |
| Equity in other comprehensive income of investee                                      | 747                         | 28       | 642                       | 339      |
| Balance at June 30  | \$16,862                    | \$13,047 | \$16,862                  | \$13,047 |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

Components of accumulated other comprehensive income were reclassified to the following lines of the consolidated statements of operations for the three and six months ended June 30, 2013 and June 30, 2012:

|   | Three months ended June 30, |         | Six months ended June 30, |         |
|---|-----------------------------|---------|---------------------------|---------|
|   | 2013                        | 2012    | 2013                      | 2012    |
| Reclassification of accumulated other comprehensive income from unrealized gains on fixed maturities and equity investments to: |                             |         |                           |         |
| Net realized (losses) gains   | \$(34                       | ) \$509 | \$(282                    | ) \$367 |
| Other-than-temporary impairment loss  | —                           | —       | —                         | —       |
| (Loss) gains before income tax (benefit) expense  | (34                         | ) 509   | (282                      | ) 367   |
| Income tax (benefit) expense  | —                           | —       | —                         | —       |
| Net (loss) gain   | \$(34                       | ) \$509 | \$(282                    | ) \$367 |

## NOTE 17 SEGMENTED INFORMATION

The Company is primarily engaged, through its subsidiaries, in the property and casualty insurance business. The Company conducts its business through the following two reportable segments: Insurance Underwriting and Insurance Services.

On September 17, 2012, the Company announced that it was restructuring its Insurance Underwriting and Insurance Services segments under two separate management teams. As a result of the Company's intent to streamline its non-standard property and casualty insurance business operations under one management team, KAI Advantage Auto, Inc. ("Advantage Auto"), formerly included in Insurance Services, is now part of Insurance Underwriting. All segmented information has been restated for all periods presented to include Advantage Auto in Insurance Underwriting.

## Insurance Underwriting Segment

Insurance Underwriting includes the following subsidiaries of the Company: Mendota Insurance Company, Mendakota Insurance Company, Universal Casualty Company, Maison Insurance Company ("Maison"), Kingsway Amigo Insurance Company ("Amigo"), Advantage Auto, Kingsway Reinsurance Corporation and Kingsway Reinsurance (Bermuda) Ltd. (collectively, "Insurance Underwriting"). In November 2012, the Company formed Maison, a Louisiana-domiciled property and casualty insurance company, which provides homeowners policies for wind and hail-related property losses of residential dwellings and certain contents. Insurance Underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers and actively conducts business in 17 states.

During the fourth quarter of 2012, the Company began taking steps to place all of Amigo into voluntary run-off. On November 19, 2012, the Florida Office of Insurance Regulation ("OIR") approved Amigo's plan to withdraw from the business of offering commercial lines insurance in Florida. On January 30, 2013, the OIR approved Amigo's plan to withdraw from the business of offering personal lines insurance in Florida. In April 2013, Kingsway filed a comprehensive run-off plan with the OIR, which outlines plans for Amigo's run-off. The comprehensive run-off plan is subject to OIR approval.

## Insurance Services Segment

Insurance Services includes the following subsidiaries of the Company: Assigned Risk Solutions Ltd. ("ARS"), IWS and TWS (collectively, "Insurance Services"). During the first quarter of 2013, Northeast Alliance Insurance Agency, LLC, formerly included in Insurance Services, was merged into ARS.

ARS is a licensed property and casualty agent, full service managing general agent and third-party administrator focused primarily on the assigned risk market. ARS is licensed to administer business in 22 states but generates its revenues primarily by operating in the states of New York and New Jersey.

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 26 states and Puerto Rico to their members.



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TWS is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC") and refrigeration industry. TWS distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. It distributes its maintenance support direct through corporate owners of retail spaces throughout the United States.

Results for the Company's reportable segments are based on the Company's internal financial reporting systems and are consistent with those followed in the preparation of the unaudited consolidated interim financial statements. The following tables provide financial data used by management. Segment assets are not allocated for management use and, therefore, are not included in the segment disclosures below.

Segment revenues for the three and six months ended June 30, 2013 and 2012 were:

| (in thousands)                              | Three months ended June 30, |          | Six months ended June 30, |          |
|---|-----------------------------|----------|---------------------------|----------|
|   | 2013                        | 2012     | 2013                      | 2012     |
| Revenues:                                   |                             |          |                           |          |
| Insurance Underwriting:                     |                             |          |                           |          |
| Net premiums earned                         | \$28,297                    | \$30,985 | \$56,365                  | \$60,252 |
| Other income                                | 2,199                       | 1,866    | 4,656                     | 3,753    |
| Total Insurance Underwriting                | 30,496                      | 32,851   | 61,021                    | 64,005   |
| Insurance Services:                         |                             |          |                           |          |
| Service fee and commission income           | 12,052                      | 8,138    | 25,176                    | 17,667   |
| Total Insurance Services                    | 12,052                      | 8,138    | 25,176                    | 17,667   |
| Total segment revenues                      | 42,548                      | 40,989   | 86,197                    | 81,672   |
| Net investment income                       | 816                         | 797      | 1,396                     | 1,623    |
| Net realized gains (losses)                 | 32                          | (23      | ) (1,377                  | ) 250    |
| Other-than-temporary impairment loss        | (1,800                      | ) (488   | ) (1,800                  | ) (488   |
| Gain (loss) on change in fair value of debt | 2,338                       | (2,418   | ) (6,613                  | ) (6,749 |
| Other income not allocated to segments      | (25                         | ) 878    | (264                      | ) 74     |
| Total revenues                              | \$43,909                    | \$39,735 | \$77,539                  | \$76,382 |

The operating (loss) income of each segment in the following table is before income taxes and includes revenues and direct segment costs. For the three months ended June 30, 2013 and 2012, Insurance Services operating income includes amortization expense of \$0.3 million and zero, respectively, related to its VSA in-force intangible asset. For the six months ended June 30, 2013 and 2012, Insurance Services operating income includes amortization expense of \$0.7 million and zero, respectively, related to its VSA in-force intangible asset.

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Segment (loss) income for the three and six months ended June 30, 2013 and 2012 were:

| (in thousands)  | Three months ended June 30, |           | Six months ended June 30, |            |
|---|-----------------------------|-----------|---------------------------|------------|
|   | 2013                        | 2012      | 2013                      | 2012       |
| Segment operating (loss) income                             |                             |           |                           |            |
| Insurance Underwriting                                      | \$(5,355)                   | \$(3,838) | \$(9,725)                 | \$(6,963)  |
| Insurance Services  | (60)                        | 991       | 1,289                     | 2,724      |
| Total segment operating loss                                | (5,415)                     | (2,847)   | (8,436)                   | (4,239)    |
| Net investment income                                       | 816                         | 797       | 1,396                     | 1,623      |
| Net realized gains (losses)                                 | 32                          | (23)      | (1,377)                   | 250        |
| Other-than-temporary impairment loss                        | (1,800)                     | (488)     | (1,800)                   | (488)      |
| Gain (loss) on change in fair value of debt                 | 2,338                       | (2,418)   | (6,613)                   | (6,749)    |
| Other income and expenses not allocated to segments, net    | (2,611)                     | (803)     | (5,589)                   | (4,527)    |
| Interest expense  | (1,927)                     | (1,916)   | (3,760)                   | (3,765)    |
| Amortization of intangible assets not allocated to segments | (181)                       | —         | (412)                     | —          |
| Impairment of asset held for sale                           | (1,446)                     | —         | (1,446)                   | —          |
| Loss on buy-back of debt                                    | —                           | —         | (24)                      | —          |
| Equity in net income (loss) of investee                     | —                           | 97        | 255                       | (2,169)    |
| Loss before income tax (benefit) expense                    | \$(10,194)                  | \$(7,601) | \$(27,806)                | \$(20,064) |
| Income tax (benefit) expense                                | (525)                       | 116       | (801)                     | 175        |
| Net loss  | \$(9,669)                   | \$(7,717) | \$(27,005)                | \$(20,239) |

Net premiums earned by line of business for the three and six months ended June 30, 2013 and 2012 were:

| (in thousands)                   | Three months ended June 30, |          | Six months ended June 30, |          |
|----------------------------------|-----------------------------|----------|---------------------------|----------|
|                                  | 2013                        | 2012     | 2013                      | 2012     |
| Insurance Underwriting:          |                             |          |                           |          |
| Private passenger auto liability | \$19,176                    | \$20,415 | \$37,837                  | \$39,820 |
| Auto physical damage             | 8,330                       | 7,515    | 16,173                    | 14,819   |
| Total non-standard automobile    | 27,506                      | 27,930   | \$54,010                  | \$54,639 |
| Commercial auto liability        | 97                          | 3,057    | 746                       | 5,613    |
| Homeowners                       | 694                         | —        | 1,609                     | —        |
| Other                            | —                           | (2)      | —                         | —        |
| Total net premiums earned        | \$28,297                    | \$30,985 | \$56,365                  | \$60,252 |

## NOTE 18 RESTRUCTURING

On September 17, 2012, the Company announced that it was restructuring its Insurance Underwriting and Insurance Services segments under two separate management teams. As part of the restructuring, the Company intends to streamline its non-standard property and casualty insurance business operations. Specific to Insurance Underwriting, during the fourth quarter of 2012, the Company began taking steps to place all of Amigo into voluntary run-off. On November 19, 2012, the OIR approved Amigo's plan to withdraw from the business of offering commercial lines insurance in Florida. On January 30, 2013, the OIR approved Amigo's plan to withdraw from the business of offering personal lines insurance in Florida. In April 2013, Kingsway filed a comprehensive run-off plan with the OIR, which outlines plans for Amigo's run-off. The comprehensive run-off plan is subject to OIR approval.





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As part of the restructuring, the Company will reduce staffing levels to be consistent with placing Amigo into run-off. The Company continues to estimate that Insurance Underwriting will incur approximately \$2.0 million in cash severance expenses due to reductions-in-force as part of the restructuring, and the Company now expects that these expenses will be incurred during the period beginning with the announcement through the end of 2013. From the time the restructuring was announced on September 17, 2012 through June 30, 2013, the Company has incurred severance expense of \$1.6 million.

Changes in the restructuring liability, which is included in accrued expenses and other liabilities in the consolidated balance sheets, and the related restructuring expense for the three and six months ended June 30, 2013 is as follows:

| (in thousands)                               | Three months ended June 30, 2013 |                   |         |
|--|----------------------------------|-------------------|---------|
|  | Severance                        | Lease abandonment | Total   |
| Restructuring liability, beginning of period | \$486                            | \$1,139           | \$1,625 |
| Restructuring expense                        | 127                              | 20                | 147     |
| Cash payments                                | (569)                            | (88)              | (657)   |
| Restructuring liability, end of period       | \$44                             | \$1,071           | \$1,115 |
|  |                                  |                   |         |
| (in thousands)                               | Six months ended June 30, 2013   |                   |         |
|  | Severance                        | Lease abandonment | Total   |
| Restructuring liability, beginning of period | \$214                            | \$1,207           | \$1,421 |
| Restructuring expense                        | 886                              | 41                | 927     |
| Cash payments                                | (1,056)                          | (177)             | (1,233) |
| Restructuring liability, end of period       | \$44                             | \$1,071           | \$1,115 |

## NOTE 19 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value amounts represent estimates of the consideration that would currently be agreed upon between knowledgeable, willing parties who are under no compulsion to act. Fair value is best evidenced by quoted bid or ask price, as appropriate, in an active market. Where bid or ask prices are not available, such as in an illiquid or inactive market, the closing price of the most recent transaction of that instrument subject to appropriate adjustments as required is used. Where quoted market prices are not available, the quoted prices of similar financial instruments or valuation models with observable market based inputs are used to estimate the fair value. These valuation models may use multiple observable market inputs, including observable interest rates, foreign exchange rates, index levels, credit spreads, equity prices, counterparty credit quality, corresponding market volatility levels and option volatilities. Minimal management judgment is required for fair values calculated using quoted market prices or observable market inputs for models. Greater subjectivity is required when making valuation adjustments for financial instruments in inactive markets or when using models where observable parameters do not exist. Also, the calculation of estimated fair value is based on market conditions at a specific point in time and may not be reflective of future fair values. For the Company's financial instruments carried at cost or amortized cost, the book value is not adjusted to reflect increases or decreases in fair value due to market fluctuations, including those due to interest rate changes, as it is the Company's intention to hold them until there is a recovery of fair value, which may be to maturity.

The Company classifies its investments in fixed maturities and equity investments as available-for-sale and reports these investments at fair value. The Company's LROC preferred units, senior unsecured debentures and subordinated debt are measured and reported at fair value.

Fair values of common stock equity investments are considered to approximate quoted market values based on the latest bid prices in active markets. Fair values of fixed maturities and preferred stock equity investments for which no active market exists are derived from quoted market prices of similar instruments or other third-party evidence. The fair value of the LROC preferred units is based on quoted market prices, and the fair value of the subordinated debt is estimated using an internal model based on significant market observable inputs. The fair values of senior

unsecured debentures, for which no active market exists, are derived from quoted market prices of similar instruments or other third-party evidence.

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

The Company employs a fair value hierarchy to categorize the inputs it uses in valuation techniques to measure the fair value. The extent of use of quoted market prices (Level 1), valuation models using observable market information (Level 2) and internal models without observable market information (Level 3) in the valuation of the Company's financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012 was as follows:

(in thousands)

|  | Total     | June 30, 2013<br>Fair Value Measurements at the End of the<br>Reporting Period Using |   |  |
|--|-----------|--|---|--|
|  |           | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1)        | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Recurring fair value measurements                                  |           |  |   |  |
| Assets:  |           |  |   |  |
| Fixed maturities:  |           |  |   |  |
| U.S. government, government agencies and<br>authorities            | \$26,751  | \$—  | \$26,751  | \$—  |
| Canadian government  | 4,182     | —  | 4,182   | —  |
| States municipalities and political subdivisions                   | 7,275     | —  | 7,275   | —  |
| Mortgage-backed  | 298       | —  | 298   | —  |
| Asset-backed securities and collateralized<br>mortgage obligations | 158       | —  | 158   | —  |
| Corporate  | 33,592    | —  | 33,592  | —  |
| Total fixed maturities   | 72,256    | —  | 72,256  | —  |
| Equity investments:  |           |  |   |  |
| Common stock   | 14,910    | 14,910   | —   | —  |
| Preferred stock  | 16,200    | —  | 16,200  | —  |
| Total equity investments   | 31,110    | 14,910   | 16,200  | —  |
| Other investments  | 3,031     | —  | 3,031   | —  |
| Short-term investments   | 586       | —  | 586   | —  |
| Total assets   | \$106,983 | \$14,910   | \$92,073  | \$—  |
| Liabilities:   |           |  |   |  |
| LROC preferred units   | 14,204    | 14,204   | —   | —  |
| Senior unsecured debentures  | 26,356    | —  | 26,356  | —  |
| Subordinated debt  | 26,674    | —  | 26,674  | —  |
| Total liabilities  | \$67,234  | \$14,204   | \$53,030  | \$—  |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

(in thousands)

|  | Total    | December 31, 2012<br>Fair Value Measurements at the End of the<br>Reporting Period Using |   |  |
|--|----------|--|---|--|
|  |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1)            | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
| Recurring fair value measurements                                  |          |  |   |  |
| Assets:  |          |  |   |  |
| Fixed maturities:  |          |  |   |  |
| U.S. government, government agencies and<br>authorities            | \$24,915 | \$—  | \$24,915  | \$—  |
| Canadian government  | 3,782    | —  | 3,782   | —  |
| States municipalities and political subdivisions                   | 7,345    | —  | 7,345   | —  |
| Mortgage-backed  | 5,043    | —  | 5,043   | —  |
| Asset-backed securities and collateralized<br>mortgage obligations | 1,092    | —  | 1,092   | —  |
| Corporate  | 37,357   | —  | 37,357  | —  |
| Total fixed maturities   | 79,534   | —  | 79,534  | —  |
| Equity investments:  |          |  |   |  |
| Common stock   | 3,548    | 3,548  | —   | —  |
| Other investments  | 2,000    | —  | 2,000   | —  |
| Short-term investments   | 585      | —  | 585   | —  |
| Total assets   | \$85,667 | \$3,548  | \$82,119  | \$—  |
| Liabilities:   |          |  |   |  |
| LROC preferred units   | 13,655   | 13,655   | —   | —  |
| Senior unsecured debentures  | 23,730   | —  | 23,730  | —  |
| Subordinated debt  | 23,774   | —  | 23,774  | —  |
| Total liabilities  | \$61,159 | \$13,655   | \$47,504  | \$—  |

## NOTE 20 RELATED PARTY TRANSACTIONS

Related party transactions, including services provided to or received by the Company's subsidiaries, are carried out in the normal course of operations and are measured in part by the amount of consideration paid or received as established and agreed by the parties. Management believes that consideration paid for such services in each case approximates fair value. Except where disclosed elsewhere in these unaudited consolidated interim financial statements, the following is a summary of related party transactions.

In August 2011, the Company and its subsidiary, 1347 Advisors, entered into a management services agreement with United Insurance Holdings Corp. ("United"), a third-party. This agreement provided that 1347 Advisors supply the services of an interim Chief Financial Officer to United, as well as certain strategy consulting, corporate development, corporate finance and actuarial services. Pursuant to the management services agreement, Hassan Baqar was appointed interim Chief Financial Officer at United. Mr. Baqar is currently a Managing Director of 1347 Advisors as well as a Vice President of KAI. Mr. Larry G. Swets, Jr., Chief Executive Officer and President of the Company, also

served on the Board of Directors of United. In February 2012, Amigo received a letter from the OIR which stated that Amigo, the Company and its subsidiaries, and United are affiliated entities due to their common managerial control. As a result of the foregoing, among other things, the Company may not transfer any assets to United or any of its affiliates without the prior written approval of the OIR. Subsequently, the Company and United mutually

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agreed to terminate their management services agreement effective April 2, 2012. Furthermore, Mr. Swets resigned as a member of United's Board of Directors effective April 5, 2012.

NOTE 21 COMMITMENTS AND CONTINGENCIES

(a) Legal proceedings:

In connection with its operations in the ordinary course of business, the Company and its subsidiaries are named as defendants in various actions for damages and costs allegedly sustained by the plaintiffs. While it is not possible to estimate the loss, or range of loss, if any, that may be incurred in connection with any of the various proceedings at this time, it is possible that individual actions may result in a loss having a material adverse effect on the Company's financial condition or results of operations.

(b) Guarantee:

The Company provided a letter of guarantee to a third-party for customs bonds reinsured by Lincoln General Insurance Company ("Lincoln General"). This guarantee may require the Company to compensate the third-party if Lincoln General is unable to fulfill its obligations relating to the customs bonds. On May 25, 2012, U.S. Customs made a demand on the third-party for \$12.0 million plus interest. At this time, no demand has been made of the Company. The Company continues to believe that it has substantial defenses and that the potential loss is not probable; therefore, no liability has been recorded in the financial statements at June 30, 2013.

(c) Commitment:

During the second quarter of 2012, the Company entered into a subscription agreement to commit up to \$6.0 million of capital to allow for participation in a limited liability investment which invests principally in income-producing real estate. At June 30, 2013, the unfunded commitment was \$4.0 million.

## KINGSWAY FINANCIAL SERVICES INC.

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## NOTE 22 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION

In 2004, KAI issued \$125.0 million 7.5% senior notes due in 2014 through a private offering. These notes are redeemable at KAI's option on or after February 1, 2009 and are fully and unconditionally guaranteed by the Company (a "Guarantor"). The following tables show condensed consolidating financial information for the Company as of June 30, 2013 and December 31, 2012 and for the periods ended June 30, 2013 and 2012, with a separate column for the Guarantor, the issuer and the other businesses of the Company combined ("Non-Guarantor subsidiaries").

Condensed Consolidating Statement of Operations  
For the six months ended June 30, 2013

|  | KFSI<br><br>(a<br>"Guarantor") | KAI<br><br>(an "Issuer") | Other<br>subsidiaries<br>(the<br>"Non-Guarantor<br>subsidiaries") | Consolidation<br>adjustments | Total       |
|--|--------------------------------|--------------------------|---|------------------------------|-------------|
| Revenue:   |                                |                          |   |                              |             |
| Net premiums earned  | \$—                            | \$—                      | \$ 56,365   | \$—                          | \$56,365    |
| Service fee and commission income  | —                              | —                        | 25,176  | —                            | 25,176      |
| Net investment income, net realized losses, other-than-temporary impairment loss and other income              | (273                           | )(2,742                  | )5,626  | —                            | 2,611       |
| Gain (loss) on change in fair value of debt  | —                              | (6,063                   | )(550   | )—                           | (6,613 )    |
| Total revenues   | (273                           | )(8,805                  | )86,617   | —                            | 77,539      |
| Expenses:  |                                |                          |   |                              |             |
| Loss and loss adjustment expenses  | —                              | —                        | 46,446  | —                            | 46,446      |
| Commissions and premium taxes  | —                              | —                        | 11,883  | —                            | 11,883      |
| Other expenses   | 1,499                          | 3,280                    | 38,708  | —                            | 43,487      |
| Interest expense   | —                              | 5,686                    | (1,926  | )—                           | 3,760       |
| Total expenses   | 1,499                          | 8,966                    | 95,111  | —                            | 105,576     |
| Loss before loss on buy-back of debt, equity in net income (loss) of investee and income tax (benefit) expense | (1,772                         | )(17,771                 | )(8,494   | )—                           | (28,037 )   |
| Loss on buy-back of debt   | —                              | (24                      | )—  | —                            | (24 )       |
| Equity in net income (loss) of investee  | —                              | 255                      | —   | —                            | 255         |
| Loss before income tax (benefit) expense   | (1,772                         | )(17,540                 | )(8,494   | )—                           | (27,806 )   |
| Income tax (benefit) expense   | (710                           | )—                       | (91   | )—                           | (801 )      |
| Equity in undistributed net (loss) income of subsidiaries  | (25,941                        | )(8,685                  | )—  | 34,626                       | —           |
| Net (loss) income  | \$(27,003                      | )\$(26,225               | )\$(8,403   | )\$34,626                    | \$(27,005 ) |

## KINGSWAY FINANCIAL SERVICES INC.

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|  | Condensed Consolidating Statement of Operations<br>For the six months ended June 30, 2012 |               |   |                              |             |
|--|---|---------------|---|------------------------------|-------------|
|  | KFSI  | KAI           | Other<br>subsidiaries<br>(the<br>"Non-Guarantor<br>subsidiaries") | Consolidation<br>adjustments | Total       |
|  | (a<br>"Guarantor")  | (an "Issuer") |   |                              |             |
| Revenue:   |   |               |   |                              |             |
| Net premiums earned  | \$—   | \$—           | \$ 60,252   | \$—                          | \$60,252    |
| Service fee and commission income  | —   | —             | 17,667  | —                            | 17,667      |
| Net investment income, net realized losses, other-than-temporary impairment loss and other income              | 169   | 1,714         | 3,329   | —                            | 5,212       |
| Gain (loss) on change in fair value of debt  | —   | (3,504        | ) (3,245  | ) —                          | (6,749 )    |
| Total revenues   | 169   | (1,790        | ) 78,003  | —                            | 76,382      |
| Expenses:  |   |               |   |                              |             |
| Loss and loss adjustment expenses  | —   | —             | 45,391  | —                            | 45,391      |
| Commissions and premium taxes  | —   | —             | 9,166   | —                            | 9,166       |
| Other expenses   | 2,258   | 1,842         | 31,855  | —                            | 35,955      |
| Interest expense   | —   | 7,113         | (3,348  | ) —                          | 3,765       |
| Total expenses   | 2,258   | 8,955         | 83,064  | —                            | 94,277      |
| Loss before loss on buy-back of debt, equity in net income (loss) of investee and income tax (benefit) expense | (2,089  | ) (10,745     | ) (5,061  | ) —                          | (17,895 )   |
| Equity in net income (loss) of investee  | —   | (2,165        | ) (4  | ) —                          | (2,169 )    |
| Loss before income tax (benefit) expense   | (2,089  | ) (12,910     | ) (5,065  | ) —                          | (20,064 )   |
| Income tax (benefit) expense   | —   | —             | 175   | —                            | 175         |
| Equity in undistributed net (loss) income of subsidiaries  | (15,850   | ) (5,746      | ) —   | 21,596                       | —           |
| Net (loss) income  | \$(17,939   | ) \$(18,656   | ) \$( 5,240   | ) \$21,596                   | \$(20,239 ) |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

|  | Condensed Consolidating Balance Sheets |               |                                    |                           |            |
|--|--|---------------|------------------------------------|---------------------------|------------|
|  | As of June 30, 2013                    |               |                                    |                           |            |
|  | KFSI                                   | KAI           | Other subsidiaries                 | Consolidation adjustments | Total      |
|  | (a "Guarantor")                        | (an "Issuer") | (the "Non-Guarantor subsidiaries") |                           |            |
| <b>Assets:</b>   |  |               |                                    |                           |            |
| Investments in subsidiaries                              | \$35,207                               | \$192,544     | \$—                                | \$(227,751)               | )\$—       |
| Total investments  | —                                      | 16,547        | 139,809                            | (47,105)                  | )109,251   |
| Investment in investee                                   | —                                      | —             | —                                  | —                         | —          |
| Cash and cash equivalents                                | 1,917                                  | 6,871         | 62,563                             | —                         | 71,351     |
| Goodwill   | —                                      | —             | 9,484                              | —                         | 9,484      |
| Intangible assets  | —                                      | 7,803         | 42,766                             | —                         | 50,569     |
| Other assets   | 4,088                                  | 238,199       | 472,730                            | (609,887)                 | )105,130   |
| Asset held for sale                                      | —                                      | —             | 7,291                              | —                         | 7,291      |
| Total assets   | 41,212                                 | 461,964       | 734,643                            | (884,743)                 | )353,076   |
| <b>Liabilities and Equity:</b>                           |  |               |                                    |                           |            |
| <b>Liabilities:</b>                                      |  |               |                                    |                           |            |
| Unpaid loss and loss adjustment expenses:                | —                                      | —             | 99,843                             | —                         | 99,843     |
| Unearned premiums  | —                                      | —             | 47,308                             | —                         | 47,308     |
| LROC preferred units                                     | —                                      | —             | 14,204                             | —                         | 14,204     |
| Senior unsecured debentures                              | —                                      | 26,356        | —                                  | —                         | 26,356     |
| Subordinated debt  | —                                      | 26,674        | —                                  | —                         | 26,674     |
| Notes payable  | —                                      | 70,222        | (70,222)                           | )—                        | —          |
| Other liabilities  | 295                                    | 18,588        | 98,538                             | (19,647)                  | )97,774    |
| Total liabilities  | 295                                    | 141,840       | 189,671                            | (19,647)                  | )312,159   |
| <b>Equity:</b>   |  |               |                                    |                           |            |
| Common stock   | 296,621                                | 829,681       | 560,562                            | (1,390,243)               | )296,621   |
| Additional paid-in capital                               | 15,824                                 | —             | —                                  | —                         | 15,824     |
| Accumulated deficit                                      | (289,784)                              | )(482,744)    | )(24,054)                          | )506,798                  | (289,784 ) |
| Accumulated other comprehensive income (loss)            | 16,862                                 | (26,813)      | )8,464                             | 18,349                    | 16,862     |
| Shareholders' equity attributable to common shareholders | 39,523                                 | 320,124       | 544,972                            | (865,096)                 | )39,523    |
| Noncontrolling interests in consolidated subsidiaries    | 1,394                                  | —             | —                                  | —                         | 1,394      |
| Total equity   | 40,917                                 | 320,124       | 544,972                            | (865,096)                 | )40,917    |
| Total liabilities and equity                             | \$41,212                               | \$461,964     | \$734,643                          | \$(884,743)               | )\$353,076 |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

|  | Condensed Consolidating Balance Sheets |               |                                    |                           |            |
|--|--|---------------|------------------------------------|---------------------------|------------|
|  | As of December 31, 2012                |               |                                    |                           |            |
|  | KFSI                                   | KAI           | Other subsidiaries                 | Consolidation adjustments | Total      |
|  | (a "Guarantor")                        | (an "Issuer") | (the "Non-Guarantor subsidiaries") |                           |            |
| Assets:  |  |               |                                    |                           |            |
| Investments in subsidiaries                              | \$58,709                               | \$185,079     | \$—                                | \$(243,788)               | )\$—       |
| Total investments  | —                                      | —             | 142,499                            | (54,499)                  | )88,000    |
| Investment in investee                                   | —                                      | 36,723        | —                                  | 5,010                     | 41,733     |
| Cash and cash equivalents                                | 1,932                                  | 6,371         | 72,510                             | —                         | 80,813     |
| Goodwill   | —                                      | —             | 8,421                              | —                         | 8,421      |
| Intangible assets  | —                                      | 7,803         | 42,780                             | —                         | 50,583     |
| Other assets   | 5,004                                  | 229,206       | 452,199                            | (591,896)                 | )94,513    |
| Asset held for sale                                      | —                                      | —             | 8,737                              | —                         | 8,737      |
| Total assets   | 65,645                                 | 465,182       | 727,146                            | (885,173)                 | )372,800   |
| Liabilities and Equity:                                  |  |               |                                    |                           |            |
| Liabilities:   |  |               |                                    |                           |            |
| Unpaid loss and loss adjustment expenses:                | —                                      | —             | 106,564                            | —                         | 106,564    |
| Unearned premiums  | —                                      | —             | 45,047                             | —                         | 45,047     |
| LROC preferred units                                     | —                                      | —             | 13,655                             | —                         | 13,655     |
| Senior unsecured debentures                              | —                                      | 23,730        | —                                  | —                         | 23,730     |
| Subordinated debt  | —                                      | 23,774        | —                                  | —                         | 23,774     |
| Notes payable  | —                                      | 70,222        | (70,222)                           | )—                        | —          |
| Other liabilities  | 231                                    | 16,374        | 92,145                             | (14,134)                  | )94,616    |
| Total liabilities  | 231                                    | 134,100       | 187,189                            | (14,134)                  | )307,386   |
| Equity:  |  |               |                                    |                           |            |
| Common stock   | 296,621                                | 829,681       | 572,079                            | (1,401,760)               | )296,621   |
| Additional paid-in capital                               | 15,757                                 | —             | —                                  | —                         | 15,757     |
| Accumulated deficit                                      | (262,069)                              | )(474,768     | )(35,045                           | )509,813                  | (262,069 ) |
| Accumulated other comprehensive income (loss)            | 14,762                                 | (23,831)      | )2,923                             | 20,908                    | 14,762     |
| Shareholders' equity attributable to common shareholders | 65,071                                 | 331,082       | 539,957                            | (871,039)                 | )65,071    |
| Noncontrolling interests in consolidated subsidiaries    | 343                                    | —             | —                                  | —                         | 343        |
| Total equity   | 65,414                                 | 331,082       | 539,957                            | (871,039)                 | )65,414    |
| Total liabilities and equity                             | \$65,645                               | \$465,182     | \$727,146                          | \$(885,173)               | )\$372,800 |



## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

|   | Condensed Consolidating Statement of Cash Flows<br>For the six months ended June 30, 2013 |               |   |                              |             |
|---|---|---------------|---|------------------------------|-------------|
|   | KFSI  | KAI           | Other<br>subsidiaries<br>(the<br>"Non-Guarantor<br>subsidiaries") | Consolidation<br>adjustments | Total       |
|   | (a<br>"Guarantor")  | (an "Issuer") |   |                              |             |
| Cash provided by (used in):   |   |               |   |                              |             |
| Operating activities:   |   |               |   |                              |             |
| Net (loss) income   | \$(27,003   | )\$(26,225    | )\$ (8,403  | ) \$34,626                   | \$(27,005 ) |
| Equity in undistributed net income (loss) of subsidiaries   | 25,941  | 8,685         | —   | (34,626                      | )—          |
| Loss on change in fair value of debt  | —   | 6,063         | 550   | —                            | 6,613       |
| Other   | 1,047   | 4,431         | (10,678   | ) —                          | (5,200 )    |
| Net cash used in operating activities   | (15   | )(7,046       | )(18,531  | ) —                          | (25,592 )   |
| Investing activities:   |   |               |   |                              |             |
| Proceeds from sales and maturities of fixed maturities, equity investments and investment in investee | —   | 13,638        | 11,255  | —                            | 24,893      |
| Purchase of investments   | —   | (1,056        | )(5,803   | ) —                          | (6,859 )    |
| Acquisition of business   | —   | —             | (1,052  | ) —                          | (1,052 )    |
| Other   | —   | (4,453        | )4,184  | —                            | (269 )      |
| Net cash provided by investing activities   | —   | 8,129         | 8,584   | —                            | 16,713      |
| Financing activities:   |   |               |   |                              |             |
| Redemption of senior unsecured debentures   | —   | (583          | )—  | —                            | (583 )      |
| Net cash (used in) provided by financing activities   | —   | (583          | )—  | —                            | (583 )      |
| Net (decrease) increase in cash and cash equivalents  | (15   | )500          | (9,947  | ) —                          | (9,462 )    |
| Cash and cash equivalents at beginning of period  | 1,932   | 6,371         | 72,510  | —                            | 80,813      |
| Cash and cash equivalents at end of period  | \$1,917   | \$6,871       | \$ 62,563   | \$—                          | \$71,351    |

## KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

Condensed Consolidating Statement of Cash Flows  
For the six months ended June 30, 2012

|   | KFSI<br>(a<br>"Guarantor") | KAI<br>(an "Issuer") | Other<br>subsidiaries<br>(the<br>"Non-Guarantor<br>subsidiaries") | Consolidation<br>adjustments | Total       |
|---|----------------------------|----------------------|---|------------------------------|-------------|
| Cash provided by (used in):                               |                            |                      |   |                              |             |
| Operating activities:                                     |                            |                      |   |                              |             |
| Net (loss) income   | \$(17,939                  | )\$(18,656           | )\$ (5,240  | ) \$21,596                   | \$(20,239 ) |
| Equity in undistributed net income (loss) of subsidiaries | 15,850                     | 5,746                | —   | (21,596                      | )—          |
| Loss on change in fair value of debt                      | —                          | 3,504                | 3,245   | —                            | 6,749       |
| Other   | (8,181                     | )3,583               | (21,480   | ) 8,631                      | (17,447 )   |
| Net cash (used in) provided by operating activities       | (10,270                    | )(5,823              | )(23,475  | ) 8,631                      | (30,937 )   |
| Investing activities:                                     |                            |                      |   |                              |             |
| Proceeds from sales and maturities of fixed maturities    | —                          | —                    | 51,145  | —                            | 51,145      |
| Purchase of fixed maturities                              | —                          | —                    | (42,223   | ) —                          | (42,223 )   |
| Other   | —                          | (184                 | )(318   | ) —                          | (502 )      |
| Net cash provided by (used in) investing activities       | —                          | (184                 | )8,604  | —                            | 8,420       |
| Financing activities:                                     |                            |                      |   |                              |             |
| Common stock issued                                       | 132                        | 8,631                | —   | (8,631                       | )132        |
| Net cash (used in) provided by financing activities       | 132                        | 8,631                | —   | (8,631                       | )132        |
| Net (decrease) increase in cash and cash equivalents      | (10,138                    | )2,624               | (14,871   | ) —                          | (22,385 )   |
| Cash and cash equivalents at beginning of period          | 22,389                     | 873                  | 62,224  | —                            | 85,486      |
| Cash and cash equivalents at end of period                | \$12,251                   | \$3,497              | \$ 47,353   | \$—                          | \$63,101    |

KINGSWAY FINANCIAL SERVICES INC.

Notes to Consolidated Financial Statements (Unaudited) June 30, 2013

NOTE 23 SUBSEQUENT EVENT

On July 8, 2013, the Company announced that it had entered into a non-binding letter of intent with Atlas to sell its holdings of Atlas preferred stock for 90.0% of liquidation value, or \$16.2 million. On August 1, 2013, the Company announced that the transaction had closed. Under the terms of the transaction, Atlas paid the Company at closing \$7.5 million in cash, plus approximately \$0.8 million from cash raised by Atlas from the exercise of certain outstanding Atlas warrants. If any amount of the purchase price remains unpaid as of January 3, 2014, such unpaid amount will be repayable not later than April 30, 2014 pursuant to one or more promissory notes entered into by Atlas.

## KINGSWAY FINANCIAL SERVICES INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Forward Looking Statements

Management's Discussion and Analysis includes "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Words such as "expects", "believes", "anticipates", "intends", "estimates", "seeks" and variations and similar words and expressions are intended to identify such forward looking statements. Such forward looking statements relate to future events or future performance, but reflect Kingsway management's current beliefs, based on information currently available. A number of factors could cause actual events, performance or results to differ materially from the events, performance and results discussed in the forward looking statements. For information identifying important factors that could cause actual results to differ materially from those anticipated in the forward looking statements, see Kingsway's securities filings, including its Annual Report on Form 10-K for the year ended December 31, 2012 ("2012 Annual Report"). In addition to the general factors listed in the 2012 Annual Report, our potential inability to complete the proposed rights offering could cause actual results and financial condition to differ materially from estimated results and financial condition. The Company's securities filings can be accessed on the Canadian Securities Administrators' website at [www.sedar.com](http://www.sedar.com), and on the EDGAR section of the U.S. Securities and Exchange Commission's website at [www.sec.gov](http://www.sec.gov) or through the Company's website at [www.kingsway-financial.com](http://www.kingsway-financial.com). Except as expressly required by applicable securities law, the Company disclaims any intention or obligation to update or revise any forward looking statements whether as a result of new information, future events or otherwise.

## OVERVIEW

Kingsway is a holding company and is primarily engaged, through its subsidiaries, in the property and casualty insurance business. The Company conducts its business through the following two reportable segments: Insurance Underwriting and Insurance Services.

On September 17, 2012, the Company announced that it was restructuring its Insurance Underwriting and Insurance Services segments under two separate management teams. As a result of the Company's intent to streamline its non-standard property and casualty insurance business operations under one management team, KAI Advantage Auto, Inc. ("Advantage Auto"), formerly included in Insurance Services, is now part of Insurance Underwriting. All segmented information has been restated for all periods presented to include Advantage Auto in Insurance Underwriting.

Insurance Underwriting includes the following subsidiaries of the Company: Mendota Insurance Company ("Mendota"), Mendakota Insurance Company ("Mendakota"), Universal Casualty Company ("UCC"), Maison Insurance Company ("Maison"), Kingsway Amigo Insurance Company ("Amigo"), Advantage Auto, Kingsway Reinsurance Corporation and Kingsway Reinsurance (Bermuda) Ltd. In November 2012, the Company formed Maison, a Louisiana-domiciled property and casualty insurance company, which provides homeowners policies for wind and hail-related property losses of residential dwellings and certain contents. Throughout Management's Discussion and Analysis, the term "Insurance Underwriting" is used to refer to this segment.

Insurance Underwriting actively conducts business in 17 states. For the three months ended June 30, 2013, production in the following states represented 78.4% of the Company's gross premiums written: Florida (20.6%), Illinois (15.3%), Texas (15.0%), California (12.5%), Colorado (7.5%) and Nevada (7.5%). For the six months ended June 30, 2013, production in the following states represented 81.7% of the Company's gross premiums written: Florida (25.2%), Illinois (15.8%), Texas (14.2%), California (11.3%), Colorado (8.2%) and Nevada (7.0%).

Insurance Underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers. For the three months ended June 30, 2013, non-standard automobile insurance accounted for 86.9% (91.7% year to date) of the Company's gross premiums written.

During the fourth quarter of 2012, the Company began taking steps to place all of Amigo into voluntary run-off. On November 19, 2012, the Florida Office of Insurance Regulation ("OIR") approved Amigo's plan to withdraw from the business of offering commercial lines insurance in Florida. On January 30, 2013, the OIR approved Amigo's plan to withdraw from the business of offering personal lines insurance in Florida. In April 2013, Kingsway filed a



comprehensive run-off plan with the OIR, which outlines plans for Amigo's run-off. The comprehensive run-off plan is subject to OIR approval.

Insurance Services includes the following subsidiaries of the Company: Assigned Risk Solutions Ltd. ("ARS"), IWS Acquisition Corporation ("IWS") and Trinity Warranty Solutions LLC ("TWS"). During the first quarter of 2013, Northeast Alliance Insurance Agency, LLC, formerly included in Insurance Services, was merged into ARS. In May 2013, the Company's subsidiary, TWS,

KINGSWAY FINANCIAL SERVICES INC.

acquired certain intangible assets of Trinity Warranty Corp. Throughout Management's Discussion and Analysis, the term "Insurance Services" is used to refer to this segment.

ARS is a licensed property and casualty agent, full service managing general agent and third-party administrator focused primarily on the assigned risk market. ARS is licensed to administer business in 22 states but generates its revenues primarily by operating in the states of New York and New Jersey.

IWS is a licensed motor vehicle service agreement company and is a provider of after-market vehicle protection services distributed by credit unions in 26 states and Puerto Rico to their members.

TWS is a provider of warranty products and maintenance support to consumers and businesses in the heating, ventilation, air conditioning ("HVAC") and refrigeration industry. TWS distributes its warranty products through original equipment manufacturers, HVAC distributors and commercial and residential contractors. It distributes its maintenance support direct through corporate owners of retail spaces throughout the United States.

#### NON-U.S. GAAP FINANCIAL MEASURES

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the U.S. GAAP presentation of net loss, we show certain statutory reporting information and other non-U.S. GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are operating loss, gross premiums written, net premiums written, and underwriting ratios.

Following is a list of non-U.S. GAAP measures found throughout this report with their definitions, relationships to U.S. GAAP measures and explanations of their importance to our operations.

#### Operating Loss

Operating loss represents one measure of the pretax profitability of our segments and is derived by subtracting direct segment expenses from direct segment revenues. Revenues and expenses are presented in the consolidated statements of operations but are not subtotaled by segment. However, this information is available in total and by segment in Note 17, "Segmented Information" to the unaudited consolidated interim financial statements, regarding reportable segment information. The nearest comparable U.S. GAAP measure is loss before income tax (benefit) expense which, in addition to operating loss (income), includes net investment income, net realized gains (losses), other-than-temporary impairment loss, gain (loss) on change in fair value of debt, other income, general and administrative expenses, restructuring expense, interest expense, amortization of intangible assets, impairment of asset held for sale, loss on buy-back of debt, and equity in net income (loss) of investee.

#### Gross Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in Insurance Underwriting.

#### Net Premiums Written

While net premiums earned is the related U.S. GAAP measure used in the consolidated statements of operations, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in Insurance Underwriting.

#### Underwriting Ratios

Kingsway, like many insurance companies, analyzes performance based on underwriting ratios such as loss, expense and combined ratios. The loss ratio is derived by dividing the amount of net loss and loss adjustment expenses incurred by net premiums earned. The expense ratio is derived by dividing the sum of commissions and premium taxes and general and administrative expenses by net premiums earned. The combined ratio is the sum of the loss ratio and the expense ratio. A combined ratio below 100% demonstrates underwriting profit whereas a combined ratio over 100% demonstrates an underwriting loss.



## KINGSWAY FINANCIAL SERVICES INC.

## Critical Accounting Estimates and Assumptions

The preparation of unaudited consolidated interim financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect application of policies and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from these estimates. Estimates and their underlying assumptions are reviewed on an ongoing basis. Changes in estimates are recorded in the accounting period in which they are determined. The critical accounting estimates and assumptions in the accompanying unaudited consolidated interim financial statements include the provision for unpaid loss and loss adjustment expenses, valuation of fixed maturities and equity investments, valuation of deferred income taxes, valuation of intangible assets, goodwill recoverability, deferred acquisition costs, and fair value assumptions for debt obligations.

The Company's critical accounting estimates and assumptions are described in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2012 Annual Report. There has been no material change subsequent to December 31, 2012 to the information previously disclosed in the 2012 Annual Report with respect to these critical accounting estimates and assumptions.

## RESULTS OF CONTINUING OPERATIONS

A reconciliation of total segment operating loss to net loss for the three and six months ended June 30, 2013 and 2012 is presented in Table 1 below:

Table 1 Segment (Loss) Income

For the three and six months ended June 30 (in millions of dollars)

|   | For the three months ended June 30, |         |         | For the six months ended June 30, |          |         |
|---|-------------------------------------|---------|---------|-----------------------------------|----------|---------|
|   | 2013                                | 2012    | Change  | 2013                              | 2012     | Change  |
| Segment operating (loss) income                             |                                     |         |         |                                   |          |         |
| Insurance Underwriting                                      | (5.4)                               | ) (3.8) | ) (1.6) | ) (9.8)                           | ) (6.9)  | ) (2.9) |
| Insurance Services  | (0.1)                               | ) 1.0   | (1.1)   | ) 1.2                             | 2.7      | (1.5)   |
| Total segment operating loss                                | (5.5)                               | ) (2.8) | ) (2.7) | ) (8.6)                           | ) (4.2)  | ) (4.4) |
| Net investment income                                       | 0.8                                 | 0.8     | —       | 1.4                               | 1.6      | (0.2)   |
| Net realized gains (losses)                                 | —                                   | —       | —       | (1.4)                             | ) 0.3    | (1.7)   |
| Other-than-temporary impairment loss                        | (1.8)                               | ) (0.5) | ) (1.3) | ) (1.8)                           | ) (0.5)  | ) (1.3) |
| Gain (loss) on change in fair value of debt                 | 2.3                                 | (2.4)   | ) 4.7   | (6.7)                             | ) (6.7)  | ) —     |
| Other income and expenses not allocated to segments, net    | (2.6)                               | ) (0.9) | ) (1.7) | ) (5.5)                           | ) (4.6)  | ) (0.9) |
| Interest expense  | (1.9)                               | ) (1.9) | ) —     | (3.7)                             | ) (3.7)  | ) —     |
| Amortization of intangible assets not allocated to segments | (0.1)                               | ) —     | (0.1)   | ) (0.4)                           | ) —      | (0.4)   |
| Impairment of asset held for sale                           | (1.4)                               | ) —     | (1.4)   | ) (1.4)                           | ) —      | (1.4)   |
| Loss on buy-back of debt                                    | —                                   | —       | —       | —                                 | —        | —       |
| Equity in net income (loss) of investee                     | —                                   | 0.1     | (0.1)   | ) 0.3                             | (2.2)    | ) 2.5   |
| Loss before income tax (benefit) expense                    | (10.2)                              | ) (7.6) | ) (2.6) | ) (27.8)                          | ) (20.0) | ) (7.8) |
| Income tax (benefit) expense                                | (0.5)                               | ) 0.1   | (0.6)   | ) (0.8)                           | ) 0.2    | (1.0)   |
| Net loss  | (9.7)                               | ) (7.7) | ) (2.0) | ) (27.0)                          | ) (20.2) | ) (6.8) |

## Net Loss and Diluted Loss Per Share

In the second quarter of 2013, we incurred a net loss of \$9.7 million (\$0.74 per diluted share) compared to \$7.7 million (\$0.59 per diluted share) in the second quarter of 2012. For the six months ended June 30, 2013, we incurred a net loss of \$27.0 million



## KINGSWAY FINANCIAL SERVICES INC.

(\$2.05 per diluted share) compared to \$20.2 million (\$1.54 per diluted share) for the six months ended June 30, 2012. The net loss for the three and six months ended June 30, 2013 is attributable to operating losses in Insurance Underwriting, corporate general expenses, interest expense, other-than-temporary impairment loss, impairment of asset held for sale and change in fair value of debt. The net loss for the three and six months ended June 30, 2012 is due to operating losses in Insurance Underwriting, corporate general expenses, interest expense, loss on the change in fair value of debt and equity in net loss of investee.

## Insurance Underwriting

For the three months ended June 30, 2013, Insurance Underwriting gross premiums written were \$32.0 million compared to \$32.2 million for the three months ended June 30, 2012, representing a 0.6% decrease (\$75.6 million year to date compared to \$71.5 million prior year to date, representing a 5.7% increase). Net premiums written decreased 20.9% to \$21.9 million for the three months ended June 30, 2013 compared with \$27.7 million for the three months ended June 30, 2012 (\$54.1 million year to date compared to \$61.6 million prior year to date, representing a 12.2% decrease). Net premiums earned decreased 8.7% to \$28.3 million for the three months ended June 30, 2013 compared with \$31.0 million for the three months ended June 30, 2012 (\$56.4 million year to date compared with \$60.3 million prior year to date, representing a 6.5% decrease).

The increase in year-to-date gross premiums written is the result of increased non-standard automobile premium volumes at Mendota and Mendakota and business written by Maison, which did not begin operations until the fourth quarter of 2012, partially offset by a decrease in non-standard and commercial automobile premium volumes at Amigo reflecting the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off. The decrease in net premiums written and earned for the quarter and year to date is the result of quota share reinsurance agreements entered into by Mendota and Mendakota effective July 1, 2012 and continuing in place through June 30, 2013 as well as decreased premium volumes at Amigo and UCC, as a result of their respective run-off plans.

The Insurance Underwriting operating loss increased to \$5.4 million for the three months ended June 30, 2013 (\$9.8 million year to date) compared with \$3.8 million for the three months ended June 30, 2012 (\$6.9 million prior year to date). The increase in operating loss for the three months ended June 30, 2013 is primarily attributed to a decrease in net premiums earned combined with significant catastrophe losses incurred by Mendota and Mendakota along with continued development of first quarter catastrophe losses suffered by Maison. The operating loss for the six months ended June 30, 2013 similarly reflects these developments.

The Insurance Underwriting loss ratio for the second quarter of 2013 was 81.3% compared to 76.2% for the second quarter of 2012 (76.6% for the six months ended June 30, 2013 compared with 75.3% for the same period in 2012). The increase in the loss ratio for the three months ended June 30, 2013 is primarily due to decreased net premiums earned at Amigo and UCC, as a result of their run-off plans, as well as the effect of storm-related losses incurred at Maison during the first quarter of 2013 and Mendota and Mendakota during the second quarter of 2013. The more modest increase in the loss ratio for the six months ended June 30, 2013 similarly reflects these developments offset somewhat by the effect of favorable development on unpaid loss and loss adjustment expenses at UCC during the first quarter of 2013.

The Insurance Underwriting expense ratio was 45.4% for the second quarter of 2013 compared to 41.6% for the second quarter of 2012 (48.9% for the six months ended June 30, 2013 compared with 41.9% for the same period in 2012). The increase in the expense ratio for the three and six months ended June 30, 2013 is a derivative effect of the 8.7% decrease (6.5% year to date) in net premiums earned cited above, which has made it more difficult for Insurance Underwriting to cover its fixed overhead expenses; furthermore, Insurance Underwriting incurred \$0.9 million of severance expense for the six months ended June 30, 2013 related to its previously announced restructuring.

The Insurance Underwriting combined ratio was 126.7% in the second quarter 2013 compared with 117.8% in the second quarter of 2012 (125.5% for the six months ended June 30, 2013 compared with 117.2% for the same period in 2012), reflecting the dynamics which affected the loss and expense ratios.

The Insurance Underwriting operating loss includes policy fee income of \$2.2 million and \$1.9 million for the three months ended June 30, 2013 and 2012, respectively (\$4.7 million for the six months ended June 30, 2013 compared with \$3.8 million for the same period in 2012); however, when calculating expense and combined ratios under U.S.

GAAP, policy fee income is excluded.

Insurance Services

The Insurance Services service fee and commission income increased 49.4% to \$12.1 million for the three months ended June 30, 2013 (\$25.2 million year to date) compared with \$8.1 million for the three months ended June 30, 2012 (\$17.7 million prior year to date). This increase was primarily driven by the inclusion of IWS in 2013 following its acquisition during the fourth quarter of 2012. The Insurance Services operating (loss) income decreased to a loss of \$0.1 million for the three months ended June 30, 2013 (income of \$1.2 million year to date) compared with income of \$1.0 million for the three months ended June 30, 2012 (income

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of \$2.7 million prior year to date). This decrease is primarily due to increased amortization expense as a result of the acquisition of IWS during the fourth quarter of 2012, as noted above, as well as reduced premium volumes managed by ARS. Insurance Services operating income for the three months ended June 30, 2013 includes amortization expense of \$0.3 million (\$0.7 million year to date) related to its VSA in-force intangible asset.

Net Investment Income

Net investment income was \$0.8 million in the second quarter of 2013 (\$1.4 million year to date) compared to \$0.8 million in the second quarter of 2012 (\$1.6 million prior year to date). The year-to-date decrease is primarily a result of a decline in the Company's total investments, cash and cash equivalents which resulted from reduced volumes of business and acceleration of claim payments in Insurance Underwriting. Additionally, yields on fixed maturities remain at historically low levels such that reinvestment of maturing investments occurs at yields lower than the yields on the maturing investments.

Net Realized Gains (Losses)

The Company incurred net realized gains in the second quarter of 2013 of \$0.0 million (net realized losses of \$1.4 million year to date) compared to net realized losses of \$0.0 million in the second quarter of 2012 (net realized gains of \$0.3 million prior year to date). The year-to-date net realized losses in 2013 resulted primarily from the sale of Atlas Financial Holdings, Inc. ("Atlas") common stock during the first quarter of 2013. As more fully described in Note 7, "Investment in Investee," to the unaudited consolidated interim financial statements, the Company realized a loss of \$1.7 million during the first quarter of 2013 related to the sale of Atlas common stock. The net realized gains in 2012 resulted from the liquidation of equity investments and fixed maturities in Insurance Underwriting.

Other-Than-Temporary Impairment Loss

On July 8, 2013, the Company announced that it had entered into a non-binding letter of intent with Atlas to sell its holdings of Atlas preferred stock for 90% of liquidation value, or \$16.2 million. On August 1, 2013, the Company announced that the transaction had closed. As a result, the Company recorded a write-down for other-than-temporary impairment related to its investment in Atlas preferred stock of \$1.8 million for the three and six months ended June 30, 2013.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, a write-down of zero for other-than-temporary impairment related to other investments was recorded for the three and six months ended June 30, 2013 compared to \$0.5 million for the three months ended June 30, 2012 (\$0.5 million prior year to date).

There were no write-downs related to fixed maturities for other-than-temporary impairments for the three and six months ended June 30, 2013 and June 30, 2012.

Gain (Loss) on Change in Fair Value of Debt

The gain on change in fair value of debt amounted to \$2.3 million in the second quarter of 2013 (loss of \$6.7 million year to date) compared to a loss of \$2.4 million in the second quarter of 2012 (loss of \$6.7 million prior year to date). The gain for the second quarter of 2013 is primarily due to a decrease in the fair values of the Company's subordinated debt and LROC preferred units. The 2013 year to date loss is due to increase in the fair values of the Company's senior unsecured debentures, subordinated debt and LROC preferred units, whereas the 2012 loss for the second quarter and year to date is primarily due to an increase in the fair values of the Company's subordinated debt and LROC preferred units.

Other Income and Expenses not Allocated to Segments, Net

Other income and expenses not allocated to segments was a net expense of \$2.6 million in the second quarter of 2013 compared to \$0.9 million in the second quarter of 2012 (\$5.5 million year to date compared to \$4.6 million prior year to date). The increase in net expense for the three and six months ended June 30, 2013 is primarily due to \$1.3 million more in foreign exchange losses (\$0.6 million year to date) and \$0.4 million more of salary and benefits expense in the second quarter of 2013 (\$0.5 million year to date) compared to the second quarter of 2012.

Interest Expense

Interest expense for the second quarter of 2013 was \$1.9 million (\$3.8 million year to date) compared to \$1.9 million in the second quarter of 2012 (\$3.8 million prior year to date).

Amortization of Intangible Assets Not Allocated to Segments



The Company's intangible assets with definite useful lives are amortized over their estimated useful lives. Amortization of intangible assets not allocated to segments was \$0.1 million for the second quarter of 2013 (\$0.4 million year to date) compared to zero in

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the second quarter of 2012 (zero prior year to date). The expense for the three and six months ended June 30, 2013 relates to the amortization of acquired database, customer-related relationships, trade name and non-compete agreement. See Note 5, "Acquisitions," to the unaudited consolidated interim financial statements for further details.

Impairment of Asset Held for Sale

As of June 30, 2013, property consisting of building and land located in Miami, Florida with a carrying value of \$7.3 million was classified as held for sale. During the second quarter of 2013, the Company recorded a write-down of \$1.4 million related to the asset held for sale.

Loss on Buy-Back of Debt

No debt repurchases were made during the second quarter of 2013. During the first quarter of 2013, the Company purchased for \$0.6 million, including accrued interest, \$0.6 million of par value of its senior unsecured debentures with a carrying value of \$0.6 million, including accrued interest, recording a loss of \$0.0 million. The Company subsequently canceled the acquired debentures. During the three and six months ended June 30, 2012, respectively, the Company did not buy-back any of its outstanding debt.

Equity in Net Income (Loss) of Investee

As discussed further in Note 7, "Investment in Investee," to the unaudited consolidated interim financial statements, during the second quarter of 2013, the Company discontinued the use of the equity method of accounting for its former investee, Atlas. Prior to discontinuing the use of the equity method of accounting for Atlas, the Company used a reporting lag of three months to report its proportionate share of Atlas' results. Accordingly, equity in net income of investee recorded during the first quarter of 2013 of \$0.3 million relates to the Company's proportionate share of Atlas' results reported for the three months ended December 31, 2012. For the three months ended June 30, 2012, the Company recorded \$0.1 million of income from this investment (loss of \$2.2 million prior year to date).

Income Tax (Benefit) Expense

Income tax benefit for the second quarter of 2013 was \$0.5 million (\$0.8 million year to date) compared to income tax expense of \$0.1 million in the second quarter of 2012 (\$0.2 million prior year to date). The decrease in income tax expense for the three and six months ended June 30, 2013 is primarily attributable to a Canadian income tax refund recorded in the second quarter of 2013.

## INVESTMENTS

### Portfolio Composition

All of our investments in fixed maturities and equity investments are classified as available-for-sale and are reported at fair value. At June 30, 2013, we held cash and cash equivalents and investments with a carrying value of \$180.6 million. As of June 30, 2013, we held an investments portfolio comprised primarily of fixed maturities issued by the U.S. Government, government agencies and high quality corporate issuers and equity investments in the common and preferred stock of Atlas. Investments held by our insurance subsidiaries must comply with applicable domiciliary state regulations that prescribe the type, quality and concentration of investments. Our U.S. operations typically invest in U.S. dollar-denominated instruments to mitigate their exposure to currency rate fluctuations.

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Table 2 below summarizes the carrying value of investments, including cash and cash equivalents, at the dates indicated.

TABLE 2 Carrying value of investments, including cash and cash equivalents  
(in millions of dollars, except for percentages)

| Type of investment  | June 30, 2013 | % of Total | December 31, 2012 | % of Total |
|---|---------------|------------|-------------------|------------|
| Fixed maturities:   |               |            |                   |            |
| U.S. government, government agencies and authorities            | 26.8          | 14.8 %     | 24.9              | 14.8 %     |
| Canadian government   | 4.2           | 2.3 %      | 3.8               | 2.2 %      |
| States municipalities and political subdivisions                | 7.3           | 4.0 %      | 7.3               | 4.3 %      |
| Mortgage-backed   | 0.3           | 0.2 %      | 5.0               | 2.9 %      |
| Asset-backed securities and collateralized mortgage obligations | 0.1           | 0.1 %      | 1.1               | 0.6 %      |
| Corporate   | 33.6          | 18.6 %     | 37.4              | 22.2 %     |
| Total fixed maturities  | 72.3          | 40.0 %     | 79.5              | 47.0 %     |
| Equity investments:   |               |            |                   |            |
| Common stock  | 14.9          | 8.2 %      | 3.6               | 2.1 %      |
| Preferred stock   | 16.2          | 9.0 %      | —                 | — %        |
| Total equity investments  | 31.1          | 17.2 %     | 3.6               | 2.1 %      |
| Limited liability investments                                   | 2.3           | 1.3 %      | 2.3               | 1.4 %      |
| Other investments   | 3.0           | 1.7 %      | 2.0               | 1.2 %      |
| Short-term investments  | 0.5           | 0.3 %      | 0.6               | 0.4 %      |
| Total investments   | 109.2         | 60.5 %     | 88.0              | 52.1 %     |
| Cash and cash equivalents                                       | 71.4          | 39.5 %     | 80.8              | 47.9 %     |
| Total   | 180.6         | 100.0 %    | 168.8             | 100.0 %    |

## Liquidity and Cash Flow Risk

Table 3 below summarizes the fair value by contractual maturities of the fixed maturities portfolio, excluding cash and cash equivalents, at June 30, 2013 and December 31, 2012.

TABLE 3 Fair value of fixed maturities by contractual maturity date  
(in millions of dollars)

|                                  | June 30, 2013 | % of Total | December 31, 2012 | % of Total |
|----------------------------------|---------------|------------|-------------------|------------|
| Due in less than one year        | 25.4          | 35.1 %     | 16.3              | 20.5 %     |
| Due in one through five years    | 45.4          | 62.8 %     | 56.2              | 70.7 %     |
| Due after five through ten years | 1.2           | 1.7 %      | 2.1               | 2.6 %      |
| Due after ten years              | 0.3           | 0.4 %      | 4.9               | 6.2 %      |
| Total                            | 72.3          | 100.0 %    | 79.5              | 100.0 %    |

At June 30, 2013, 97.9% of fixed maturities, including treasury bills, government bonds and corporate bonds, had contractual maturities of five years or less. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call or prepayment penalties. The Company holds cash and high-grade short-term assets which, along with fixed maturities, management believes are sufficient in amount for the payment of unpaid loss and loss adjustment expenses and other operating subsidiary obligations on a timely basis. In the event that additional cash is required to meet obligations to our policyholders and customers, we believe that the high-quality, liquid investments in the portfolios provide us with sufficient liquidity.



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## Market Risk

Market risk is the risk that we will incur losses due to adverse changes in interest or currency exchange rates and equity prices. Given our U.S. operations typically invest in U.S. dollar denominated instruments and our relatively insignificant investment in equity instruments, our primary market risk exposures in the investments portfolio are to changes in interest rates.

Because the investments portfolio is comprised of primarily fixed maturity instruments that are usually held to maturity, periodic changes in interest rate levels generally impact our financial results to the extent that the investments are recorded at market value and reinvestment yields are different than the original yields on maturing instruments. During periods of rising interest rates, the market value of the existing fixed maturities will generally decrease. The reverse is true during periods of declining interest rates.

## Credit Risk

Credit risk is defined as the risk of financial loss due to failure of the other party to a financial instrument to discharge an obligation. Credit risk arises from our positions in short-term investments, corporate debt instruments and government bonds.

The Investment and Capital Committee of the Board of Directors is responsible for the oversight of key investment policies and limits. These policies and limits are subject to annual review and approval by the Investment and Capital Committee. The Investment and Capital Committee is also responsible for ensuring that these policies are implemented and that procedures are in place to manage and control credit risk.

Table 4 below summarizes the composition of the fair value of fixed maturities, excluding cash and cash equivalents, at June 30, 2013 and December 31, 2012, by rating as assigned by Standard and Poor's ("S&P") or Moody's Investors Service ("Moody's"). Fixed maturities consist of predominantly high-quality instruments in corporate and government bonds with approximately 85.7% of those investments rated 'A' or better at June 30, 2013. During 2012, the Company reinvested cash into certain fixed maturities rated BBB/Baa. These investment grade fixed maturities purchased provide a better yield while maintaining compliance with conservative credit risk guidelines adopted by the Company.

TABLE 4 Credit ratings of fixed maturities

| Rating (S&P/Moody's)            | June 30, 2013 | December 31, 2012 |   |
|---------------------------------|---------------|-------------------|---|
| AAA/Aaa                         | 45.0          | % 45.2            | % |
| AA/Aa                           | 14.8          | 15.8              |   |
| A/A                             | 25.9          | 22.8              |   |
| Percentage rated A/A2 or better | 85.7          | % 83.8            | % |
| BBB/Baa                         | 14.3          | 16.2              |   |
| Total                           | 100.0         | % 100.0           | % |

## Other-Than-Temporary Impairment

The Company performs a quarterly analysis of its investment portfolio to determine if declines in market value are other-than-temporary. Further information regarding our detailed analysis and factors considered in establishing an other-than-temporary impairment on an investment is discussed within Note 6, "Investments," to the unaudited consolidated interim financial statements.

As a result of the analysis performed by the Company to determine declines in market value that are other-than-temporary, a write-down of zero and \$0.5 million for other-than-temporary impairment related to other investments was recorded for the three months ended June 30, 2013 and June 30, 2012, respectively (zero and \$0.5 million for the six months ended June 30, 2013 and June 30, 2012, respectively).

On July 8, 2013, the Company announced that it had entered into a non-binding letter of intent with Atlas to sell its holdings of Atlas preferred stock for 90% of liquidation value, or \$16.2 million. On August 1, 2013, the Company announced that the transaction had closed. As a result, the Company recorded a write-down for other-than-temporary impairment related to its investment in Atlas preferred stock of \$1.8 million for the three and six months ended June 30, 2013.

There were no write-downs related to fixed maturities for other-than-temporary impairments for the three and six months ended June 30, 2013 and June 30, 2012.

The length of time an individual investment may be held in an unrealized loss position may vary based on the opinion of the investment manager and their respective analyses related to valuation and to the various credit risks that may prevent us from recapturing the principal investment. In the case of an individual investment with a maturity date where the investment manager

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determines that there is little or no risk of default prior to the maturity of a holding, we would elect to hold the investment in an unrealized loss position until the price recovers or the investment matures. In situations where facts emerge that might increase the risk associated with recapture of principal, the Company may elect to sell investments at a loss.

At June 30, 2013, the gross unrealized losses for fixed maturities and equity investments amounted to \$0.1 million, and there were no unrealized losses attributable to non-investment grade fixed maturities.

At each of June 30, 2013 and December 31, 2012, all unrealized losses on individual investments were considered temporary. Fixed maturities in unrealized loss positions continued to pay interest and were not subject to material changes in their respective debt ratings. We concluded that default risk did not exist at the time and, therefore, the declines in value were considered temporary. As we have the capacity to hold these investments to maturity, no impairment provision was considered necessary.

**Limited Liability Investments**

The Company owns investments in limited liability companies ("LLCs") and a limited partnership ("LP") that primarily invest in income-producing real estate. The Company's investments in the LLCs and LP are reported as limited liability investments in the consolidated balance sheets. The real estate investments are held on a triple net lease basis whereby the lessee agrees to pay all real estate taxes, building insurance and maintenance. The real estate investments yield between 7.5% - 8% minimum preferred return on invested capital. Table 5 below presents additional information pertaining to the LLC and LP investments at June 30, 2013 and December 31, 2012.

TABLE 5 Limited liability investments  
(in millions of dollars)

|                                | Unfunded      | Carrying Value |                   |
|--------------------------------|---------------|----------------|-------------------|
|                                | Commitment    | June 30, 2013  | December 31, 2012 |
| Limited liability investments: | June 30, 2013 | June 30, 2013  | December 31, 2012 |
| Real estate held through LLC   | —             | —              | 1.0               |
| Real estate held through LP    | 4.0           | 2.0            | 1.2               |
| Other                          | —             | 0.3            | 0.1               |
| Total                          | 4.0           | 2.3            | 2.3               |

**PROPERTY AND CASUALTY UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES**

Property and casualty unpaid loss and loss adjustment expenses represent the estimated liabilities for reported loss events, incurred but not reported ("IBNR") loss events and the related estimated loss adjustment expenses.

Tables 6 and 7 present distributions, by line of business, of the provision for property and casualty unpaid loss and loss adjustment expenses gross and net of external reinsurance, respectively.

TABLE 6 Provision for property and casualty unpaid loss and loss adjustment expenses - gross  
(in millions of dollars)

| Line of Business        | June 30, 2013 | December 31, 2012 |
|-------------------------|---------------|-------------------|
| Non-standard automobile | 77.1          | 80.3              |
| Commercial automobile   | 16.6          | 19.9              |
| Other                   | 3.0           | 2.9               |
| Total                   | 96.7          | 103.1             |

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TABLE 7 Provision for property and casualty unpaid loss and loss adjustment expenses - net of reinsurance recoverable

(in millions of dollars)

| Line of Business        | June 30, 2013 | December 31, 2012 |
|-------------------------|---------------|-------------------|
| Non-standard automobile | 69.7          | 75.6              |
| Commercial automobile   | 16.1          | 19.1              |
| Other                   | 3.0           | 2.9               |
| Total                   | 88.8          | 97.6              |

## Non-Standard Automobile

At June 30, 2013 and December 31, 2012, the gross provisions for property and casualty unpaid loss and loss adjustment expenses for our non-standard automobile business were \$77.1 million and \$80.3 million, respectively.

The decrease primarily reflects the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off as well as the payment of claims related to UCC's continuing voluntary run-off. Further information regarding Amigo is discussed within "Liquidity and Capital Resources" below.

## Commercial Automobile

At June 30, 2013 and December 31, 2012, the gross provisions for property and casualty unpaid loss and loss adjustment expenses for our commercial automobile business were \$16.6 million and \$19.9 million, respectively. The decrease primarily reflects the actions begun by the Company during the fourth quarter of 2012 to place Amigo into voluntary run-off as well as the payment of claims related to UCC's continuing voluntary run-off. Further information regarding Amigo is discussed within "Liquidity and Capital Resources" below.

Information with respect to development of our provision for prior years' property and casualty unpaid loss and loss adjustment expenses is presented in Table 8.

TABLE 8 (Decrease) increase in prior years' provision for property and casualty unpaid loss and loss adjustment expenses

(in millions of dollars)

|  | Three months ended June 30, |      | Six months ended June 30, |      |
|--|-----------------------------|------|---------------------------|------|
|  | 2013                        | 2012 | 2013                      | 2012 |
| (Favorable) unfavorable change in provision for property and casualty unpaid loss and loss adjustment expenses for prior accident years: | —                           | 0.1  | (0.8                      | )0.3 |

For the three months ended June 30, 2013, the Company reported \$0.0 million of favorable development for property and casualty unpaid loss and loss adjustment expenses from prior accident years (\$0.8 million year to date). For the three months ended June 30, 2012, the Company reported \$0.1 million of unfavorable development for property and casualty unpaid loss and loss adjustment expenses from prior accident years (\$0.3 million prior year to date). The favorable development reported for the six months ended June 30, 2013 was primarily related to the decrease in property and casualty unpaid loss and loss adjustment expenses at UCC. The development reported for the three and six months ended June 30, 2012 was primarily related to the Company's allocation of its provision for unallocated loss and loss adjustment expenses between the current and prior accident years.

The Company cannot predict whether property and casualty unpaid loss and loss adjustment expenses will develop favorably or unfavorably from the amounts reported in the Company's unaudited consolidated interim financial statements. The Company believes that any such development will not have a material effect on the Company's consolidated equity but could have a material effect on the Company's consolidated financial results for a given period. See the "Critical Accounting Estimates and Assumptions" section of Management's Discussion and Analysis of Financial Condition and Results of Operations in the 2012 Annual Report for additional information pertaining to the Company's process of estimating the provision for unpaid loss and loss adjustment expenses.

## RECENTLY ISSUED ACCOUNTING STANDARDS

See Note 4, "Recently Issued Accounting Standards," to the unaudited consolidated interim financial statements for discussion of certain accounting standards that may be applicable to the Company's current and future consolidated financial statements.





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LIQUIDITY AND CAPITAL RESOURCES

The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due. The liquidity requirements of the Company and its subsidiaries have been met primarily by funds generated from operations, disposal of discontinued operations, investment maturities and income and other returns received on investments. Cash provided from these sources is used primarily for loss and loss adjustment expense payments, debt servicing and other operating expenses. The timing and amount of payments for loss and loss adjustment expenses may differ materially from our provisions for unpaid loss and loss adjustment expenses, which may create increased liquidity requirements.

Cash Flows

During the six months ended June 30, 2013, the net cash used in operating activities as reported on the unaudited consolidated statements of cash flows was \$25.6 million. This use of cash can be explained primarily by the net loss of \$27.0 million.

During the six months ended June 30, 2013, the net cash provided by investing activities as reported on the unaudited consolidated statements of cash flows was \$16.7 million. This source of cash was driven by net proceeds received from the sale of Atlas common stock of \$13.6 million during the first quarter of 2013 as further discussed in Note 7, "Investment in Investee," to the unaudited consolidated interim financial statements, and proceeds from sales and maturities of fixed maturities in excess of purchases of fixed maturities. As previously explained, the Company's insurance subsidiaries hold investments portfolios comprised primarily of fixed maturities issued by the U.S. Government, government agencies and high-quality corporate issuers which are of generally short duration and are highly liquid which enables the insurance subsidiaries to meet their liquidity needs.

During the six months ended June 30, 2013, the net cash used in financing activities as reported on the unaudited consolidated statements of cash flows was \$0.6 million. This use of cash is attributed to the buy-back of \$0.6 million of par value of senior unsecured debentures during the first quarter of 2013.

In summary, as reported on the unaudited consolidated statements of cash flows, the Company's net decrease in cash and cash equivalents during the six months ended June 30, 2013 was \$9.5 million.

The Company's Insurance Underwriting subsidiaries fund their obligations primarily through premium and investment income and maturities in the investments portfolios. The Company's Insurance Services subsidiaries fund their obligations primarily through service fee income. As a holding company, Kingsway funds its obligations, which primarily consist of interest payments on debt as well as holding company operating expenses, primarily through disposal of discontinued operations and investment in investee, as well as from receipt of dividends from its non-insurance subsidiaries. On the other hand, the operating insurance subsidiaries require regulatory approval for the return of capital and, in certain circumstances, prior to the payment of dividends. At June 30, 2013, the U.S. insurance subsidiaries of the Company were restricted from making any dividend payments without regulatory approval pursuant to the domiciliary state insurance regulations.

As of June 30, 2013, the Company has \$26.4 million principal value of outstanding debt due February 1, 2014. During the first quarter of 2013, Kingsway sold 2,625,000 shares of Atlas common stock for approximately \$13.6 million of proceeds net of commissions and transaction expenses. On July 8, 2013, the Company announced that it had entered into a non-binding letter of intent with Atlas to sell its holdings of Atlas preferred stock for 90% of liquidation value, or \$16.2 million. On August 1, 2013, the Company announced that the transaction had closed. Under the terms of the transaction, Atlas paid the Company at closing \$7.5 million in cash, plus approximately \$0.8 million from cash raised by Atlas from the exercise of certain outstanding Atlas warrants. If any amount of the purchase price remains unpaid as of January 3, 2014, such unpaid amount will be repayable not later than April 30, 2014 pursuant to one or more promissory notes entered into by Atlas. The Company also recently announced its intention to raise approximately \$12.5 million, net of fees and expenses, in the form of a rights offering with an expiry date of September 6, 2013. There can be no assurance the Company will successfully close the rights offering.

While the sale of Atlas common stock and Atlas preferred stock added substantially to the Company's liquidity, the Company still does not have the funds necessary to both retire the remaining \$26.4 million of principal value of debt due on February 1, 2014 as well as meet all of its other continuing obligations. In the event that funds available to the Company are inadequate to service its obligations, specifically the retirement of the remaining \$26.4 million principal

value of debt due February 1, 2014, the Company would need to raise capital, sell additional assets or restructure its debt obligations. The Company believes that it has the flexibility to obtain the funds needed to meet its obligations and continue to satisfy regulatory capital requirements at its insurance underwriting subsidiaries, though there can be no assurance that it will be able to meet its outstanding debt obligation due February 1, 2014.

On June 7, 2013, the Company received notification from the New York Stock Exchange ("NYSE") of the Company's non-compliance with certain NYSE standards for continued listing of its common shares. Specifically, Kingsway is below the NYSE's continued listing criteria because its average total market capitalization over a recent 30 consecutive trading day period was less than \$50 million at the same time that reported shareholders' equity was below \$50 million. Under the NYSE's continued listing

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criteria, a NYSE-listed company must maintain average market capitalization of not less than \$50 million over a 30 consecutive trading day period or reported shareholders' equity of not less than \$50 million.

The Company has 90 days from the date of the notice to submit a business plan to the NYSE demonstrating its ability to achieve compliance with the listing standards within 18 months of receiving the notice. The Company submitted a business plan to the NYSE on July 17, 2013, intended to demonstrate its ability to achieve compliance with the listing standards within 18 months of receiving the notice, and remains engaged in discussions with the NYSE regarding such business plan. During such 18-month period, Kingsway's common shares will continue to be listed and traded on the NYSE, subject to compliance with other NYSE continued listing standards; however, the consolidated tape now includes a ".BC" indicator, which will be removed at such time as the Company is deemed compliant with the NYSE's continued listing standards. Kingsway intends to address the issue through the successful completion of the Rights Offering.

The notice from the NYSE does not impact the Company's listing on the Toronto Stock Exchange ("TSX"), and its Common Shares will continue to be listed and traded on the TSX, subject to compliance with TSX continued listing standards.

There can be no assurance that the Company will regain compliance with NYSE listing standards.

#### Debt Covenants and Buy-backs

Certain debentures issued by the Company contain negative covenants in their trust indentures, placing limitations and restrictions over certain actions without the prior written consent of the indenture trustees. Included in the negative covenants is the limitation on the incurrence of additional debt in the event that the total debt-to-total capital ratio or the senior debt-to-total capital ratio exceeds 50% or 35%, respectively. The total debt is calculated on a pro-forma basis taking into account the issuance of additional debt. The debentures also include covenants limiting the issuance and sale of voting stock of restricted subsidiaries, the payment of dividends or any other payment in respect of capital stock of the Company, or the retirement of debt subordinate to the debentures covered by the trust indentures if, after giving effect to such payments as described in the trust indentures, the total debt-to-total capital ratio exceeds 50%. Throughout 2013 and 2012, the Company has continued to experience losses. The reduction in equity as a result of these ongoing losses can detrimentally impact the Company's capital flexibility by triggering negative covenants in its trust indentures described above and/or limiting the dividend capacity of the operating subsidiaries. As of June 30, 2013, the Company's total debt-to-total capital and senior debt-to-total capital ratios were 65.8% and 34.6%, respectively. These ratios have been calculated based on the unaudited consolidated interim financial statements prepared in accordance with U.S. GAAP, under which the Company's equity has materially improved primarily due to fair valuation of its debt.

The Company launched a debt buy-back initiative during 2009, pursuant to which it has retired a substantial amount of its outstanding debt. No debt repurchases were made during the second quarter of 2013. During the first quarter of 2013, the Company purchased for \$0.6 million, including accrued interest, \$0.6 million of par value of its senior unsecured debentures with a carrying value of \$0.6 million, including accrued interest, recording a loss of \$0.0 million. The Company subsequently canceled the acquired debentures. During the three and six months ended June 30, 2012, respectively, the Company did not buy-back any of its outstanding debt.

#### Regulatory Capital

In the United States, a risk-based capital ("RBC") formula is used by the National Association of Insurance Commissioners ("NAIC") to identify property and casualty insurance companies that may not be adequately capitalized. Most states, including the domiciliary states of our insurance subsidiaries, have adopted the NAIC RBC requirements. In general, insurers reporting surplus as regards policyholders below 200% of the authorized control level, as defined by the NAIC, at December 31 are subject to varying levels of regulatory action, including discontinuation of operations. As of December 31, 2012, surplus as regards policyholders reported by each of our insurance subsidiaries, with the exception of Amigo, exceeded the 200% threshold.

As of December 31, 2012, Amigo's RBC was 157%, which is at the company action level, as defined by the NAIC. During the fourth quarter of 2012, the Company began taking steps to place all of Amigo into voluntary run-off. On November 19, 2012, the OIR approved Amigo's plan to withdraw from the business of offering commercial lines insurance in Florida. On January 30, 2013, the OIR approved Amigo's plan to withdraw from the business of offering

personal lines insurance in Florida. In April 2013, Kingsway filed a comprehensive run-off plan with the OIR, which outlines plans for Amigo's run-off. The comprehensive run-off plan is subject to OIR approval. The successful achievement of any run-off plan depends on future events and circumstances, the outcome of which cannot be assured. Nevertheless, the Company and Amigo expect that they will take all necessary steps to comply with the provisions of the run-off plan.

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Our reinsurance subsidiaries, which are domiciled in Barbados and Bermuda, are required by the regulators in the jurisdictions in which they operate to maintain minimum capital levels. As of June 30, 2013, the capital maintained by Kingsway Reinsurance Corporation and Kingsway Reinsurance (Bermuda) Ltd. was in excess of the regulatory capital requirements in Barbados and Bermuda, respectively.

KINGSWAY FINANCIAL SERVICES INC.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are a smaller reporting company as defined in Rule 12b-2 of the Exchange Act; therefore, pursuant to Regulation S-K, we are not required to make disclosures under this Item.

Item 4. Controls and Procedures

The Company's management performed an evaluation under the supervision and with the participation of the Company's principal executive officer and the principal financial officer, and completed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as that term is defined in Rules 13a-15(e) and 15d-15(e), as adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934, as amended ("the Exchange Act") as of June 30, 2013. Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures.

Based on that evaluation, which excluded TWS due to its recent acquisition, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective.

Effective May 22, 2013, the Company's subsidiary, TWS, acquired certain intangible assets of Trinity Warranty Corp. Since the date of acquisition, the Company has been analyzing and evaluating procedures and controls to determine their effectiveness and to make them consistent with our disclosure controls and procedures. As permitted by the SEC, TWS has been excluded from the scope of our quarterly discussion of material changes in internal control over financial reporting below.

During the Company's last fiscal quarter, there were no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting, except as described above with respect to TWS. Changes to processes, information technology systems and other components of internal control over financial reporting resulting from the acquisition of TWS are expected as the integration of these operations proceeds.

KINGSWAY FINANCIAL SERVICES INC.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information concerning pending legal proceedings is incorporated herein by reference to Note 21, "Commitments and Contingencies," to the unaudited consolidated interim financial statements in Part I of this Form 10-Q.

**Item 1A. Risk Factors**

There are no material changes with respect to those risk factors previously disclosed in our 2012 Annual Report.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None



KINGSWAY FINANCIAL SERVICES INC.

Item 6. Exhibits

- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LAB XBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase

KINGSWAY FINANCIAL SERVICES INC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KINGSWAY FINANCIAL SERVICES INC.

Date: August 8, 2013

By: /s/ Larry G. Swets, Jr.  
Larry G. Swets, Jr., President and Chief Executive Officer  
(principal executive officer)

Date: August 8, 2013

By: /s/ William A. Hickey, Jr.  
William A. Hickey, Jr., Chief Financial Officer and Executive Vice  
President  
(principal financial officer)