

**Howard Mutual Insurance
Company**

Financial Statements

For the year ended December 31, 2010

**Howard Mutual Insurance Company
Financial Statements
December 31, 2010**

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Tel: 519 352 4130
Fax: 519 352 2744
www.bdo.ca

BDO Canada LLP
155 Thames Street
PO Box 1195
Chatham ON N7M 5L8 Canada

Independent Auditors' Report

To the Policyholders of
Howard Mutual Insurance Company

We have audited the accompanying financial statements of Howard Mutual Insurance Company, which comprise the balance sheet as at December 31, 2010, and the statement of operations, statement of policyholders' equity, statement of comprehensive income and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian Generally Accepted Accounting Principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Howard Mutual Insurance Company as at December 31, 2010 and the results of its operations and its cash flows for the year then ended in accordance with Canadian Generally Accepted Accounting Principles.

BDO Canada LLP

Chartered Accountants, Licensed Public Accountants

Ridgetown, Ontario
February 1, 2011

Howard Mutual Insurance Company Balance Sheet

December 31 2010 2009

Assets

Current

Cash (Note 1)	\$ 1,599,378	\$ 2,496,582
Investments (Note 2)	31,159,170	28,546,486
Accrued interest receivable	50,822	100,868
Premiums uncollected	1,702,813	1,520,623
Reinsurance recoverable	4,576,789	5,436,091
Other accounts receivable	-	600
Prepaid expenses	4,329	438

39,093,301 **38,101,688**

Other Assets

Share of Facility Association assets	7,944	20,949
Deferred policy acquisition costs	355,223	332,832
Capital assets (Note 4)	1,890,123	1,831,631
Future income tax asset	10,800	18,100

2,264,090 **2,203,512**

\$41,357,391 **\$ 40,305,200**

Liabilities and Policyholders' Equity

Liabilities

Accounts payable	\$ 282,489	\$ 234,795
Premiums due to reinsurer	220,092	74,408
Unearned premiums	4,553,324	4,192,810
Provision for unpaid claims (Note 5)	8,551,392	9,097,740
Premium refund payable (Note 6)	660,000	650,000
Income tax payable	25,100	472,044

14,292,397 **14,721,797**

Policyholders' Equity

Policyholders' surplus	26,998,123	26,217,454
Accumulated other comprehensive income (loss)	66,871	(634,051)

27,064,994 **25,583,403**

\$41,357,391 **\$ 40,305,200**

Guarantees and Contingent Liabilities (Note 10)

On behalf of the Board:

Dan McDonald, Director

Robert W. McKinlay, Director

Howard Mutual Insurance Company Statement of Operations

For the year ended December 31	2010		2009	
Net premiums written (Note 3)	\$ 7,878,608		\$ 7,251,605	
Increase in unearned premiums	(360,515)		(350,053)	
Net premiums earned	7,518,093	100.0%	6,901,552	100.0%
Net claims incurred (Note 3)	3,137,586	41.7	2,535,404	36.7
Net adjusting expense	577,292	7.7	768,071	11.1
Commission expense	701,156	9.3	669,542	9.7
Amortization	210,135	2.8	140,945	2.0
Salaries and fees expense	766,913	10.2	752,728	10.9
Loss prevention expense	87,889	1.2	80,816	1.2
Other expenses	578,760	7.7	512,672	7.4
	6,059,731	80.6	5,460,178	79.0
	1,458,362	19.4	1,441,374	21.0
Premium refund (Note 6)	(660,028)	(8.8)	(649,834)	(9.4)
Underwriting income	798,334	10.6%	791,540	11.6%
Other items				
Net investment income (Note 7)	892,470		622,884	
Other expense (Note 8)	(750,000)		-	
	142,470		622,884	
Income before income tax	940,804		1,414,424	
Income tax expense				
Current income tax	152,835		239,620	
Future income tax	7,300		12,700	
	160,135		252,320	
Net income for the year	\$ 780,669		\$ 1,162,104	

Howard Mutual Insurance Company Statement of Policyholders' Equity

For the year ended December 31	2010	2009
Policyholders' surplus		
Balance, beginning of the year	\$ 26,217,454	\$ 25,055,350
Net income for the year	780,669	1,162,104
Balance, end of the year	26,998,123	26,217,454
Accumulated other comprehensive income (loss)		
Balance, beginning of the year	(634,051)	(1,195,921)
Other comprehensive income for the year	700,922	561,870
Balance, end of the year	66,871	(634,051)
Policyholders' equity, end of the year	\$ 27,064,994	\$ 25,583,403

Howard Mutual Insurance Company Statement of Comprehensive Income

For the year ended December 31	2010	2009
Net income for the year	\$ 780,669	\$ 1,162,104
Other comprehensive income		
Unrealized gain on available for sale securities	517,859	672,573
Reclassification to income of realized loss on available for sale securities	317,563	18,497
Related income tax effect	(134,500)	(129,200)
Other comprehensive income for the year	700,922	561,870
Comprehensive income for the year	\$ 1,481,591	\$ 1,723,974

Howard Mutual Insurance Company Statement of Cash Flows

For the year ended December 31	2010	2009
Cash flows from operating activities		
Net income	\$ 780,669	\$ 1,162,104
Items not involving cash		
Amortization	210,135	140,945
Future income tax	7,300	12,700
Bond premium amortization	-	8,944
	998,104	1,324,693
Change in non-cash working capital items		
Accrued interest receivable	50,046	11,135
Premiums uncollected	(182,190)	(209,778)
Reinsurance recoverable	859,302	161,846
Income tax	(446,944)	1,586,924
Other accounts receivable	600	(600)
Prepaid expenses	(3,891)	4,812
Facility association	13,005	(12,371)
Deferred policy acquisition costs	(22,391)	(18,628)
Accounts payable	47,694	77,082
Premiums due to reinsurer	145,684	2,849
Unearned premiums	360,514	350,053
Provision for unpaid claims	(546,348)	(1,186,309)
Premium refund payable	10,000	250,000
	1,283,185	2,341,708
Cash flows from investing activities		
Net decrease (increase) in investments	(1,911,762)	(851,610)
Additions to capital assets	(268,627)	(25,716)
	(2,180,389)	(877,326)
Net increase (decrease) in cash	(897,204)	1,464,382
Cash, beginning of the year	2,496,582	1,032,200
Cash, end of the year	\$ 1,599,378	\$ 2,496,582
Additional information		
Income taxes paid (received)	\$ 734,279	\$ (1,218,104)

Howard Mutual Insurance Company Summary of Significant Accounting Policies

December 31, 2010

Nature of business	Howard Mutual Insurance Company is incorporated under the laws of Ontario and is subject to the Ontario Insurance Act. It is licensed to write auto, property and casualty insurance in Ontario. The accounting policies of the company conform with those generally accepted in Canada and comply with the requirements for filing with the Financial Services Commission of Ontario (the "regulators").								
Revenue recognition	Insurance premiums earned are included in income on a daily pro rata basis over the life of the policies. Interest income is recognized as revenue when earned using the effective yield method. Dividend income is recognized as revenue when the dividends are declared. Gains and losses on disposal of investments are determined on a completed transaction basis.								
Deferred policy acquisition costs	Acquisition costs related to unearned premiums, which consist primarily of commissions, are deferred and amortized to income over the periods in which the premiums are earned. The method followed in determining the deferred acquisition costs limits the amount of the deferral to its realizable value by giving consideration to claims and expenses expected to be incurred as the premiums are earned.								
Reinsurance	Reinsurance premiums and reinsurance recoveries on losses incurred are recorded as reductions to the respective income and expense accounts. Estimates of amounts recoverable from the reinsurer on unpaid claims and adjustment expenses are recorded as accounts receivable. A contingent liability exists with respect to reinsurance which could become a liability of the company in the event that the reinsurer might be unable to meet its obligations under the reinsurance agreements.								
Capital assets and amortization	Capital assets are recorded at cost less accumulated amortization. Amortization is provided using the straight line method at the following rates reflecting the useful lives of the assets: <table style="margin-left: 40px;"><tr><td>Building</td><td style="text-align: right;">40 years</td></tr><tr><td>Office furniture and fixtures and computer equipment</td><td style="text-align: right;">5 years</td></tr><tr><td>Motor vehicles</td><td style="text-align: right;">4 years</td></tr><tr><td>Land improvements</td><td style="text-align: right;">10 years</td></tr></table>	Building	40 years	Office furniture and fixtures and computer equipment	5 years	Motor vehicles	4 years	Land improvements	10 years
Building	40 years								
Office furniture and fixtures and computer equipment	5 years								
Motor vehicles	4 years								
Land improvements	10 years								

Howard Mutual Insurance Company Summary of Significant Accounting Policies

December 31, 2010

**Provisions for
unpaid claims**

Unpaid claims and related adjustment expenses are determined using cash-basis evaluations plus an amount for adverse development, and are estimates of the ultimate cost of all insurance claims incurred to December 31, 2010.

The provision for unpaid claims represents the amounts needed to provide for the estimated cost of settling claims related to insured events (both reported and unreported) that have occurred on or before each balance sheet date. All provisions are periodically evaluated in light of emerging claim experience and changing circumstances. The resulting changes in estimates of the ultimate claim liability are reflected in current operations.

Income taxes

The asset and liability method of tax allocation is used in accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities, and measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to be reversed.

The company is liable for income taxes on the portion of its taxable income related to non-farm business.

Foreign currency translation

Foreign currency accounts are translated into Canadian dollars as follows:

At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the year end date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date. The resulting foreign exchange gains and losses are included in income in the current period.

Use of estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from management's best estimates as additional information becomes available in the future.

Howard Mutual Insurance Company

Summary of Significant Accounting Policies

December 31, 2010

Financial instruments

The company recognizes and measures financial assets and financial liabilities on the balance sheet when they become a party to the contractual provisions of a financial instrument. All transactions related to financial instruments are recorded on a settlement date basis. All financial instruments are measured at fair value on initial recognition. Measurement in subsequent periods depends on whether the financial instrument has been classified as held for trading, loans and receivables, available for sale or other financial liabilities.

Held for trading

Financial assets classified as held for trading are measured at fair value. The financial instrument included in this category is cash.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable repayment dates, usually with interest, that are not debt securities or instruments classified as held for trading on initial recognition. Accrued interest and accounts receivable have been classified as loans and receivables. These instruments are initially recognized at fair value. Direct and incremental transaction costs are expensed immediately. They are subsequently valued at amortized cost using the effective interest method less any provision for impairment.

Available for sale

Available for sale assets are non-derivative financial assets that are designated as available for sale or are not categorized into any of the other categories described above. Investments in equity instruments and debt securities have been classified as available for sale. They are initially recognized at fair value. Direct and incremental transaction costs are expensed immediately. They are subsequently held at fair value with gains and losses arising from changes in fair value being recognized in other comprehensive income when they have a quoted market price in an active market. Where a decline in the fair value is determined to be other than temporary, the amount of the loss is removed from other comprehensive income and recognized in the statement of operations. Investments in equity instruments classified as available for sale that do not have a quoted market price in an active market are measured at cost less any provision for impairment.

Other financial liabilities

Other financial liabilities are non-derivative financial liabilities and include accounts payable and accruals. These instruments are initially recognized at fair value. Direct and incremental transaction costs are expensed immediately. They are subsequently measured at amortized cost using the effective interest method.

Howard Mutual Insurance Company Summary of Significant Accounting Policies

December 31, 2010

Financial instruments (continued)

Fair values

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's-length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair values are determined by reference to quoted bid or asking prices as appropriate, in the most advantageous active market for that instrument to which the company has immediate access.

The estimated fair value of bonds and debentures and pooled funds are based on quoted market values. The estimated fair value of equities are determined using last bid price. The company has reviewed the values of the above investments and has determined that there are no impairments that are other than temporary due to the current economic downturn.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

1. Cash

The company's bank accounts are held at two Canadian chartered banks.

2. Investments

	2010		2009	
	Cost	Fair Value	Cost	Fair Value
Bonds issued by:				
Federal	\$ 10,089,294	\$ 10,082,224	\$ 17,227,514	\$ 16,852,703
Provincial	-	-	1,155,031	1,107,690
	10,089,294	10,082,224	18,382,545	17,960,393
Equity investments				
Canadian common	3,566,965	3,790,837	2,130,685	2,044,482
U.S. equities	1,252,630	1,109,504	886,389	809,456
Pooled funds	7,711,876	7,734,386	7,209,047	6,983,417
Other	374,160	293,752	436,960	428,235
	12,905,631	12,928,479	10,663,081	10,265,590
Other investments				
Canada Treasury Bills	7,277,175	7,277,175	-	-
Mortgage receivable (at cost)	550,000	550,000	-	-
Debentures (at cost)	298,200	298,195	298,200	298,195
Fire Mutuals Guarantee Fund (at cost)	23,097	23,097	22,308	22,308
	8,148,472	8,148,467	320,508	320,503
Total	\$ 31,143,397	\$ 31,159,170	\$ 29,366,134	\$ 28,546,486

The maximum exposure to credit risk would be the fair value as shown above.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

2. Investments (continued)

	2010		2009	
	Cost	Fair Value	Cost	Fair Value
Bonds - maturity profile				
Maturing within one year	\$ 10,089,294	\$ 10,082,224	\$ -	\$ -
Maturing over five years	-	-	18,382,545	17,960,393
	\$ 10,089,294	\$ 10,082,224	\$ 18,382,545	\$ 17,960,393

Included in investments are debentures for which it was determined during 2009 that losses in value were other than a temporary decline. These debentures were written down to their estimated fair value at December 31, 2009. The estimated fair value was calculated based on past recoveries on similar debentures in other industries. Estimates of recoverable amounts are subjective and do not necessarily result in precise determinations. Actual results could differ from management's best estimates as additional information becomes available in the future. The amount of the impairment recorded in the financial statements for the year ended December 31, 2010 was \$0 (2009 - \$132,995). The remaining debentures are recorded at cost as there is no quoted market price.

The mortgage represents advances made to date on an agreement to advance a maximum of \$1,490,000 to the Howard Mutual Foundation. The loan bears interest at Royal Bank prime rate, is due December 31, 2011 and is secured by a registered mortgage on property held by the Foundation. In the event that the Foundation receives a charitable registration number prior to the due date, the principal and interest will be donated.

3. Reinsurance

The company follows a policy of reinsuring contracts of insurance. Reinsurance does not relieve the company of primary liability as the originating insurer. In exchange for reinsurance premiums, the reinsurer has agreed to limit the liability of the company to a maximum amount on any one loss of \$325,000 in the event of a property claim, \$235,000 in the event of a liability claim and \$280,000 in the event of an automobile claim. In addition, the company has obtained reinsurance having no upper amount, which limits the company's liability to \$750,000 plus 5% of any amount above that, in the event of a series of claims arising out of a single occurrence. The reinsurance contracts also contain a "stop-loss" provision which limits the company's total liability claims occurring in the year.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

3. Reinsurance (continued)

The following table sets out the impact of reinsurance on various financial statement amounts:

	2010	2009
Premiums written		
Gross premiums written	\$ 9,426,981	\$ 8,592,615
Less: Reinsurance premiums	1,548,373	1,341,010
Net premiums written	\$ 7,878,608	\$ 7,251,605
Claims incurred		
Gross claims, net of salvage	\$ 5,075,167	\$ 5,490,463
Less: Reinsurance recoveries	2,250,534	1,930,596
	2,824,633	3,559,867
Change in reserves	312,953	(1,024,463)
Net claims incurred	\$ 3,137,586	\$ 2,535,404

4. Capital assets

	2010		2009	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Land	\$ 41,878	\$ -	\$ 41,878	\$ -
Land improvements	24,657	7,646	24,657	4,931
Building	1,845,411	455,452	1,845,411	417,725
Computer equipment and software	447,095	213,472	175,516	124,558
Furniture and equipment	410,170	242,538	413,122	169,789
Motor vehicles	62,771	22,751	62,771	14,721
	\$ 2,831,982	\$ 941,859	\$ 2,563,355	\$ 731,724
Net Book Value		\$ 1,890,123		\$ 1,831,631

5. Provision for unpaid claims

The process of determining the provision for unpaid claims and adjustment expenses, and related amounts recoverable, involves the risk that the actual results will deviate, perhaps substantially, from the best estimates made by the company. The deviation arises because all events affecting the ultimate settlement value of claims are not known at the time the unpaid claims liability is established.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

6. Premium refund payable

The directors have approved a premium refund of \$660,000. This refund shall be paid only on property policies of policyholders in force at year end. This refund is reflected as a charge against income.

7. Investment income

Investment income is comprised of the following:

	<u>2010</u>	<u>2009</u>
Investment income		
Net gains (losses) on bonds	\$ (51,672)	\$ 320,987
Net gains (losses) on shares	160,423	(453,349)
Interest income	356,165	427,118
Dividend income	<u>482,291</u>	<u>380,226</u>
Total income	<u>947,207</u>	<u>674,982</u>
Investment expenses		
Management fees	<u>54,737</u>	<u>52,098</u>
Net investment income	<u>\$ 892,470</u>	<u>\$ 622,884</u>

8. Other expense

During the year the Company participated in a settlement relating to legal actions, which had been commenced in 2009, that had named the Company and certain of its Officers and Directors as defendants. The settlement resolves the litigation relating to the matter and was concluded out of court without admission of liability. The litigation arose out of prior actions of a subsidiary company.

9. Rate regulation

The Company is subject to rate regulation in the automobile business that it writes. Before automobile insurance rates can be changed, a rate filing is prepared as a combined filing for most Ontario Farm Mutuals by the Farm Mutual Reinsurance Plan Inc. (FMRP). The rate filing must include actuarial justification for the rate increases or decreases. All rate filings are approved or denied by the Financial Services Commission of Ontario.

Rate regulation can affect the automobile revenues that are earned by the Company. The actual impact of rate regulation would depend on the competitive environment at the time.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

10. Guarantees and contingent liabilities

The Company is a member of the Farm Mutual Reinsurance Plan Inc. ("the Plan"), which is a general reinsurer that shares in the insurance risks originally accepted by member insurance companies. As a member of the Plan, the Company may be required to contribute additional capital to the Plan in the form of subordinated debt should the Plan's capital fall below a prescribed minimum.

Pursuant to an agreement effective January 1, 1976, the Company is a member of the Fire Mutuals Guarantee Fund ("the Fund"). The Fund was established to provide payment of outstanding policyholders' claims if a member company becomes bankrupt. As a result, the company may be required to contribute assets to their proportionate share in meeting this objective.

In common with the insurance industry in general, the Company is subject to litigation in the normal course of conducting its insurance business which is taken into account in establishing the provision for unpaid claims and adjustment expenses.

11. Capital management

The Company's objectives with respect to capital management are to maintain a capital base that is structured to exceed regulatory requirements and to best utilize capital allocations. Reinsurance is utilized to protect capital from catastrophic losses as the frequency and severity of these losses are inherently unpredictable. To limit their potential impact, catastrophe coverage limits Howard Mutual's exposure to \$750,000 plus 5% of the remaining loss. The \$750,000 net retained amount represents approximately 3% of company's capital. For the purpose of capital management, the Company has defined capital as policyholders' equity excluding accumulated other comprehensive income.

The regulators measure the financial strength of property and casualty insurers using a minimum capital test (MCT). The regulators generally expect property and casualty companies to comply with capital adequacy requirements. This test compares a company's capital against the risk profile of the organization. The risk-based capital adequacy framework assesses the risk of assets, policy liabilities and other exposures by applying various factors. The regulator indicates that the Company should produce a minimum MCT of 150%. The regulator has the authority to request more extensive reporting and can place restrictions on the company's operations if deemed necessary.

In an actuarial study done, the net risk ratio was shown to have a high correlation to the MCT. As a result of these findings the Company uses the net risk ratio to monitor capital adequacy.

The Company measures its financial strength by examining its net premiums written to capital, as defined above, ratio or net risk ratio. For the year ended December 31, 2010 the company's ratio was 0.30 (2009 - 0.29). In 2010 for every \$0.30 of net premium written the company has \$1.00 of capital in support of the net premium. In 2009 for every \$0.29 of net premium written the company has \$1.00 of capital in support of the net premium.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

12. Financial instrument risk management

Credit risk

Credit risk is the risk of loss due to the inability or unwillingness of a borrower or counterparty to fulfill its payment obligation to the Company. The Company is exposed to this risk relating to its debt holdings in its investment portfolio and the reliance on reinsurers to make payment when certain loss conditions are met.

The Company's investment policy puts limits on the bond portfolio including portfolio composition limits, issuer type limits, bond quality limits, aggregate issuer limits, corporate sector limits and general guidelines for geographic exposure. The bond portfolio remains very high quality with 100% invested in government bonds. All fixed income portfolios are measured for performance on a quarterly basis and monitored by management on a monthly basis.

Reinsurance is placed with Farm Mutual Reinsurance Plan Inc. (FMRP), a Canadian registered reinsurer. Management monitors the creditworthiness of FMRP by reviewing their annual financial statements and through ongoing communications. Reinsurance treaties are reviewed annually by management prior to renewal of the reinsurance contract.

Accounts receivables are short-term in nature and are not subject to material credit risk.

The maximum exposure to credit risk and concentration of this risk is outlined in note 2 regarding investments.

There have been no significant changes from the previous period in the exposure to risk or policies procedures and methods used to measure the risk.

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of market factors. Market factors include three types of risk: currency risk, interest rate risk, and equity risk.

The company's investment policy operates within the guidelines of the Ontario Insurance Act. An investment policy is in place and its application is monitored by the Investment Committee and the Board of Directors. Diversification techniques are utilized to minimize risk.

Currency risk

Currency risk relates to the company operating in different currencies and converting non Canadian earnings at different points in time at different foreign exchange levels when adverse changes in foreign currency exchange rates occur.

The Company's foreign exchange risk is related to its stock holdings. At December 31, 2010 the foreign portion of the equity portfolio is 8.6%. Foreign currency changes are monitored by the investment committee and holdings are adjusted when out of balance with investment policy. A 1% change in the value of the United States dollar would affect the fair value of stocks by \$11,095 which would be reflected in Other Comprehensive Income.

There have been no significant changes from the previous period in the exposure to risk or policies, procedures and methods used to measure the risk.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

12. Financial instrument risk management (continued)

Interest rate risk

Interest rate risk is the potential for financial loss caused by fluctuations in fair value or future cash flows of financial instruments because of changes in market interest rates.

The company is exposed to this risk through its interest bearing investments (T-Bills, BAs, Bonds).

Historical data and current information is used to profile the ultimate claims settlement pattern by class of insurance, which is then used in a broad sense to develop an investment policy and strategy. However, because a significant portion of the Company's assets relate to its capital rather than liabilities, the value of its interest rate based assets exceeds its interest rate based liabilities. As a result, generally, the Company's investment income will move with interest rates over the medium to long-term with short term interest rate fluctuations creating unrealized gain or losses in Other Comprehensive Income. There are no occurrences where interest would be charged on liabilities, therefore, little protection is needed to ensure the fair market value of assets will be offset by a similar change in liabilities due to an interest rate change.

The objective and policies and procedures for managing interest rate risk is to diversify the bond portfolio in such a way interest yields are maximized by examining the future interest yield curve.

At December 31, 2010, a 1% move in interest rates, with all other variables held constant, could impact the market value of bonds by \$484,094. For bonds that the Company did not sell during the year, the change during the year would be recognized as Other Comprehensive Income during the period.

There have been no significant changes from the previous period in the exposure to risk or policies, procedures and methods used to measure the risk.

Equity risk

Equity risk is the uncertainty associated with the valuation of assets arising from changes in equity markets. The company is exposed to this risk through its equity holdings within its investment portfolio.

The Company's portfolio includes Canadian stocks with fair values that move with the Toronto Stock Exchange Composite Index and United States stocks with fair values that move with the S&P 500 Index. A 10% movement in the stock markets with all other variables held constant would have an estimated affect on the fair values of the Company's Canadian common and United States common of \$675,990. For stocks that the company did not sell during the period, the change would be recognized in the asset value and in other comprehensive income. For stocks that the company did sell during the period, the change during the period and changes prior to the period would be recognized as net realized gains in income during the period.

The Company limits the total percentage of equities as part of the investment portfolio to a maximum of 25%. At December 31, 2010 the equity portion of our portfolio was 21.7%. The Company invests in equities only that are traded on the S&P/TSX 60 Index and it does not invest in other insurance companies traded on the Index.

Howard Mutual Insurance Company Notes to Financial Statements

December 31, 2010

12. Financial instrument risk management (continued)

Liquidity risk

Liquidity risk is the risk of loss from not having access to sufficient funds to meet both expected and unexpected cash demands. The Company mitigates this risk by monitoring cash activities and expected outflows. The Company's current liabilities arise as claims are made. The Company does not have material liabilities that can be called unexpectedly at the demand of a lender or client. We have no material commitments for capital expenditures and there is no need for such expenditures in the normal course of business. Claim payments are funded by current operating cash flow, including investment income.

There have been no significant changes from the previous period in the exposure to risk or policies procedures and methods used to measure the risk.

13. Fair value measurement

The Company has categorized its assets and liabilities that are carried at fair value on a recurring basis, based on the priority of the inputs to the valuation techniques used to measure fair value, into a three level fair value hierarchy. Financial assets and liabilities measured at fair value are categorized as follows:

Level 1: Fair value is based on unadjusted quoted prices for identical assets or liabilities in an active market.

Level 2: Fair value is based on quoted prices for similar assets or liabilities in active markets, valuation that is based on significant observable inputs or inputs that are derived principally for or corroborated with observable market data through correlation or other means.

Level 3: Fair value is based on valuation techniques that require one or more significant unobservable inputs or the use of broker quotes. These unobservable inputs reflect the company's assumptions about the assumptions market participants would use in pricing the assets or liabilities.

The Company did not have any significant transfers between levels 1 and 2.

	Level 1	Level 2	Level 3	Total
Bonds				
Federal	\$ -	\$ 10,082,224	\$ -	\$ 10,082,224
Canada Treasury Bills	-	7,277,175	-	7,277,175
Equity Investments				
Canadian common	3,790,837	-	-	3,790,837
U.S. equities	1,109,504	-	-	1,109,504
Pooled funds	-	7,734,386	-	7,734,386
Other	293,752	-	-	293,752
Total assets measured at fair value	\$ 5,194,093	\$ 25,093,785	\$ -	\$ 30,287,878