

State Auto Financial CORP  
Form 10-Q  
November 07, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2007

or

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-19289

**STATE AUTO FINANCIAL CORPORATION**

(Exact name of Registrant as specified in its charter)

<b>Ohio</b> (State or other jurisdiction of incorporation or organization)	<b>31-1324304</b> (I.R.S. Employer Identification No.)
<b>518 East Broad Street, Columbus, Ohio</b> (Address of principal executive offices)	<b>43215-3976</b> (Zip Code)

Registrant's telephone number, including area code: (614) 464-5000

Indicate by check mark 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

On November 1, 2007, the Registrant had 40,922,302 Common Shares outstanding.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

## PART I FINANCIAL STATEMENTS

## Item 1. Condensed Consolidated Balance Sheets

(\$ millions, except per share amount)

	September 30 2007 (unaudited)	December 31 2006 (see note 1)
<b>Assets</b>		
Fixed maturities, available for sale, at fair value (amortized cost \$1,689.3 and \$1,630.6, respectively)	\$ 1,694.5	1,647.4
Equity securities, available for sale, at fair value (cost \$199.6 and \$230.8, respectively)	258.3	284.2
Other invested assets	5.6	6.3
<b>Total investments</b>	<b>1,958.4</b>	<b>1,937.9</b>
Cash and cash equivalents	115.2	73.4
Accrued investment income and other assets	44.5	43.7
Deferred policy acquisition costs	108.0	104.0
Reinsurance recoverable on losses and loss expenses payable (affiliates \$1.9 and \$2.7, respectively)	12.4	13.5
Prepaid reinsurance premiums	5.6	6.0
Due from affiliate	24.5	17.9
Current federal income taxes	6.2	
Deferred federal income taxes	53.3	46.3
Property and equipment, at cost (net of accumulated depreciation of \$5.5 and \$5.1, respectively)	12.3	12.4
<b>Total assets</b>	<b>\$ 2,340.4</b>	<b>2,255.1</b>
<b>Liabilities and Stockholders' Equity</b>		
Losses and loss expenses payable (affiliates \$275.5 and \$281.7, respectively)	\$ 690.5	674.5
Unearned premiums (affiliates \$121.6 and \$118.4, respectively)	448.6	428.8
Notes payable (affiliates \$15.5)	118.1	118.4
Postretirement benefits	132.2	124.8
Pension benefits	9.9	16.1
Current federal income taxes		7.2
Other liabilities	42.6	51.1
<b>Total liabilities</b>	<b>1,441.9</b>	<b>1,420.9</b>
<b>Stockholders' equity:</b>		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 45.9 and 45.7 shares issued, respectively, at stated value of \$2.50 per share	114.8	114.3

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Less 4.8 and 4.7 treasury shares, respectively, at cost	<b>(61.3)</b>	(58.1)
Additional paid-in capital	<b>95.0</b>	87.3
Accumulated other comprehensive loss	<b>(20.9)</b>	(17.3)
Retained earnings	<b>770.9</b>	708.0
<b><i>Total stockholders equity</i></b>	<b>898.5</b>	834.2
<b><i>Total liabilities and stockholders equity</i></b>	<b>\$ 2,340.4</b>	2,255.1

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Condensed Consolidated Statements of Income**

(\$ millions, except per share amounts)

Three months ended

(unaudited)	September 30	
	2007	2006
Earned premiums (ceded to affiliates \$174.1 and \$172.6, respectively)	\$ 252.1	255.8
Net investment income	21.1	20.6
Net realized gains on investments	6.4	2.0
Other income (affiliates \$0.8 and \$0.7, respectively)	1.3	1.2
<b>Total revenues</b>	<b>280.9</b>	279.6
Losses and loss expenses (ceded to affiliates \$115.4 and \$99.6, respectively)	164.6	145.0
Acquisition and operating expenses	82.6	87.6
Interest expense (affiliates \$0.4)	1.9	1.9
Other expenses, net	3.2	2.7
<b>Total expenses</b>	<b>252.3</b>	237.2
<b>Income before federal income tax</b>	<b>28.6</b>	42.4
Federal income tax expense	5.4	11.2
<b>Net income</b>	<b>\$ 23.2</b>	31.2
Earnings per common share:		
Basic	\$ 0.56	0.76
Diluted	\$ 0.55	0.75
Dividends paid per common share	\$ 0.15	0.10

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Condensed Consolidated Statements of Income**

(\$ millions, except per share amounts)

Nine months ended

(unaudited)	September 30	
	2007	2006
Earned premiums (ceded to affiliates \$520.6 and \$513.8, respectively)	\$ 757.3	768.6
Net investment income	63.0	61.6
Net realized gains on investments	11.1	2.5
Other income (affiliates \$2.4 and \$2.2, respectively)	3.7	3.7
<b>Total revenues</b>	<b>835.1</b>	836.4
Losses and loss expenses (ceded to affiliates \$315.9 and \$305.4, respectively)	468.0	466.3
Acquisition and operating expenses	254.0	256.0
Interest expense (affiliates \$1.1)	5.6	5.6
Other expenses, net	9.2	9.6
<b>Total expenses</b>	<b>736.8</b>	737.5
<b>Income before federal income tax</b>	<b>98.3</b>	98.9
Federal income tax expense	20.9	23.4
<b>Net income</b>	<b>\$ 77.4</b>	75.5
Earnings per common share:		
Basic	\$ 1.88	1.85
Diluted	\$ 1.86	1.82
Dividends paid per common share	\$ 0.35	0.28

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

## Condensed Consolidated Statements of Cash Flows

<i>(\$ millions)</i>	Nine months ended	
(unaudited)	September 30	
	2007	2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 77.4	75.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	8.3	7.5
Share-based compensation	4.9	5.4
Net realized gains on investments	(11.1)	(2.5)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(3.9)	(2.0)
Accrued investment income and other assets	(1.1)	(0.1)
Net prepaid pension expense		(4.4)
Postretirement and pension benefit liabilities	2.4	6.1
Other liabilities and due to/from affiliates, net	(18.5)	(11.4)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	1.5	3.8
Losses and loss expenses payable	16.0	(24.8)
Unearned premiums	19.8	11.8
Excess tax benefits on share based awards	0.2	
Federal income taxes	(18.8)	(8.9)
<b>Net cash provided by operating activities</b>	<b>77.1</b>	<b>56.0</b>
<b>Cash flows from investing activities:</b>		
Purchases of fixed maturities available-for-sale	(280.6)	(172.1)
Purchases of equity securities available-for-sale	(34.9)	(65.2)
Purchases of other invested assets	(0.7)	(0.6)
Maturities, calls and pay downs of fixed maturities available-for-sale	68.6	61.0
Sales of fixed maturities available-for-sale	148.0	86.3
Sales of equity securities available-for-sale	77.5	77.4
Sales of other invested assets	1.7	1.7
Net additions of property and equipment	(0.4)	(0.2)
<b>Net cash used in investing activities</b>	<b>(20.8)</b>	<b>(11.7)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	2.5	6.2
Payments to acquire treasury shares	(2.7)	
Excess tax benefits on share based awards	0.2	2.5
Payment of dividends	(14.5)	(11.4)
Change in securities lending collateral		99.0
Change in securities lending obligation		(99.0)
<b>Net cash used in financing activities</b>	<b>(14.5)</b>	<b>(2.7)</b>



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Net increase in cash and cash equivalents	<b>41.8</b>	41.6
Cash and cash equivalents at beginning of period	<b>73.4</b>	28.7
<b>Cash and cash equivalents at end of period</b>	<b>\$ 115.2</b>	70.3
<u>Supplemental disclosures:</u>		
Federal income taxes paid	<b>\$ 39.3</b>	29.4
Interest paid (affiliates \$1.1)	<b>\$ 4.2</b>	4.2

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, (Unaudited)

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### 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation ( State Auto Financial or the Company ) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required for complete financial statements. In the opinion of the Company's management, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation in accordance with U.S. generally accepted accounting principles ( GAAP ) have been included. Operating results for the nine month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K ). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2006 Form 10-K.

Certain items in the prior period consolidated financial statements have been reclassified to conform to the 2007 presentation.

#### *Adoption of Recent Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) ( SFAS 158 ) that requires employers with defined benefit pension and postretirement benefit plans other than pensions (collectively benefit plans ) to recognize the funded status of their benefit plans in their balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end balance sheet date thereby eliminating the use of an earlier measurement date and provide additional disclosures. The new measurement date requirement is not effective until fiscal years ending after December 15, 2008. On December 31, 2006, the Company adopted the recognition and disclosure provisions of SFAS 158, which had no effect on the Company's consolidated statement of income for year ended December 31, 2006, or for any prior period presented in the 2006 Form 10-K, and it will not affect the Company's operating results in future periods. Adopting SFAS 158 required the Company to recognize the funded status (i.e. the difference between the fair value of plan assets and the benefit obligations) of its benefit plans in the December 31, 2006 balance sheet, with a corresponding adjustment to other comprehensive loss, net of tax of \$63.9 million. The adoption did not have an impact on the Company's debt covenants. At December 31, 2006, the Company continued to use the earlier measurement date of September 30, and is currently reviewing the transition alternatives available and the related impact.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which was effective for fiscal years beginning after December 15, 2006. FIN 48 clarified the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provided guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted the provisions of FIN 48, on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized no increase in the liability for unrecognized tax benefits. See Note 7 for additional required disclosures.

In February 2006, the FASB issued SFAS 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 ( SFAS 155 ), which was effective for all financial instruments acquired or issued after the beginning of an entity's fiscal year after September 15, 2006. SFAS 155 permits fair value re-measurement for any hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation, clarifies which interest only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets in order to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company adopted this guidance effective January 1, 2007 and there was no impact on the Company's financial statements.



STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

In September 2005, the Accounting Standards Executive Committee issued Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* (SOP 05-1), which was effective for fiscal years beginning after December 15, 2006. SOP 05-1 provides guidance on accounting for deferred acquisition costs associated with modifications to or the internal replacement of insurance contracts. SOP 05-1 focuses on modifications to contracts with integrated product features and internal replacement of contracts in which the new contract offers product features not included in the old contract when both were priced together. The Company's insurance contracts include only nonintegrated contract features as defined in SOP 05-1, which are contract features that provide coverage that is underwritten and priced only for that incremental insurance coverage and that do not result in re-underwriting or re-pricing of other components of the contract. Nonintegrated contract features do not change the existing base contract and do not require further evaluation under SOP 05-1. The Company adopted this guidance effective January 1, 2007 and there was no impact on the Company's financial statements.

*Pending Adoption of Accounting Pronouncements*

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* (SFAS 157), which is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. The statement imposes no new requirements for additional fair-value measures in financial statements. The Company is currently assessing the impact of this new guidance and plans to adopt this guidance effective January 1, 2008.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 expands the standards under SFAS 157 to provide entities with a one-time election to measure existing financial instruments and certain other items at fair value at the date of adoption. SFAS 159 also amends SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities* to require a specific presentation of investments categorized as available-for-sale. This statement is effective for the first fiscal year that begins after November 15, 2007. The Company is currently assessing the impact of this new guidance and plans to adopt this guidance effective January 1, 2008.

**2. Earnings per Common Share**

The following table sets forth the computation of basic and diluted earnings per common share:

*(in millions, except per share amounts)*

	Three months ended		Nine months ended	
	September 30		September 30	
	2007	2006	2007	2006
<b>Numerator:</b>				
Net income for basic earnings per share				