

ALFA CORP
Form 10-Q
August 04, 2004
[Table of Contents](#)

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For Quarter Ended June 30, 2004

Commission File Number 0-11773

ALFA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State of Other Jurisdiction of
Incorporation or Organization)

063-0838024
(IRS Employer
Identification No.)

2108 East South Boulevard, Montgomery, Alabama 36116

(Mail: P. O Box 11000, Montgomery, Alabama 36191-0001)

(Address and Zip Code of Principal Executive Offices)

Edgar Filing: ALFA CORP - Form 10-Q

Registrant's Telephone Number Including Area Code (334) 288-3900

None

Former name, former address and former fiscal year if changed since last report

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 the number of shares outstanding of each of the issuer's classes of Common Stock, as of the close of the period covered by this report.

Class

Outstanding June 30, 2004

Common Stock, \$1.00 par value

80,014,751 shares

Table of Contents

ALFA CORPORATION

INDEX

| | <u>Page No.</u> |
|--|------------------------|
| Part I. | |
| Financial Information | |
| (Consolidated Unaudited) | |
| Item 1. | |
| Financial Statements | |
| <u>Balance Sheets (June 30, 2004 and December 31, 2003)</u> | 3 |
| <u>Statements of Income, Six Months and Three Months ended June 30, 2004 and 2003</u> | 4 |
| <u>Statements of Comprehensive Income, Six and Three Months ended June 30, 2004 and 2003</u> | 5 |
| <u>Statements of Cash Flows, Six Months ended June 30, 2004 and 2003</u> | 6 |
| <u>Notes to Financial Statements</u> | 7 |
| <u>Report of Independent Registered Public Accounting Firm</u> | 17 |
| Item 2. | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 18 |
| Item 3. | |
| <u>Market Risk Disclosures</u> | 36 |
| Item 4. | |
| <u>Controls and Procedures</u> | 37 |
| Part II. | |
| <u>Other Information</u> | |
| Item 1. | |
| <u>Legal Proceedings</u> | 38 |
| Item 2. | |
| <u>Changes in Securities and Use of Proceeds</u> | 39 |
| Item 3. | |
| <u>Defaults Upon Senior Securities</u> | 39 |
| Item 4. | |
| <u>Submission of Matters to a Vote of Security Holders</u> | 39 |
| Item 5. | |
| <u>Other Information</u> | 39 |
| Item 6. | |
| <u>Exhibits and Reports on Form 8-K</u> | 39 |

Table of Contents

ALFA CORPORATION

CONSOLIDATED BALANCE SHEETS

| | June 30, 2004 | December 31, 2003 |
|---|-------------------------|-------------------------|
| | (Unaudited) | |
| Assets | | |
| Investments: | | |
| Fixed Maturities Held for Investment, at amortized cost (fair value \$140,411 in 2004 and \$173,214 in 2003) | \$ 129,731 | \$ 158,623 |
| Fixed Maturities Available for Sale, at fair value (amortized cost \$1,263,415,155 in 2004 and \$1,108,673,538 in 2003) | 1,287,434,798 | 1,166,418,720 |
| Equity Securities, at fair value (cost \$85,335,325 in 2004 and \$116,063,831 in 2003) | 106,907,554 | 135,082,791 |
| Investment Real Estate (net of accumulated depreciation of \$0 in 2004 and \$1,677,073 in 2003) | | 2,495,534 |
| Policy Loans | 57,154,778 | 55,282,441 |
| Collateral Loans | 107,503,812 | 101,876,180 |
| Commercial Leases | 147,834,406 | 118,121,257 |
| Other Long-term Investments | 122,303,409 | 111,450,952 |
| Short-term Investments | 38,015,870 | 111,252,991 |
| Total Investments | 1,867,284,358 | 1,802,139,489 |
| Cash | 10,480,330 | 10,892,516 |
| Accrued Investment Income | 16,001,722 | 15,569,095 |
| Accounts Receivable | 22,715,112 | 16,689,765 |
| Reinsurance Balances Receivable | 5,501,547 | 5,815,682 |
| Due from Affiliates | 2,606,611 | 2,203,955 |
| Deferred Policy Acquisition Costs | 188,131,558 | 176,252,537 |
| Other Assets | 12,940,996 | 15,511,547 |
| Total Assets | \$ 2,125,662,234 | \$ 2,045,074,586 |
| Liabilities | | |
| Policy Liabilities and Accruals - Property and Casualty Insurance | \$ 148,286,403 | \$ 153,831,653 |
| Policy Liabilities and Accruals - Life Insurance Interest - Sensitive Products | 540,080,179 | 508,592,148 |
| Policy Liabilities and Accruals - Life Insurance - Other Products | 174,888,607 | 165,161,507 |
| Unearned Premiums | 184,212,327 | 170,292,775 |
| Dividends to Policyholders | 10,907,058 | 10,939,667 |
| Premium Deposit and Retirement Deposit Funds | 6,267,114 | 6,296,861 |
| Deferred Income Taxes | 39,713,417 | 50,383,545 |
| Other Liabilities | 53,036,032 | 53,460,552 |
| Due to Affiliates | 16,098,788 | 16,065,895 |
| Commercial Paper | 193,504,954 | 164,443,769 |
| Notes Payable | 70,000,000 | 70,000,000 |
| Notes Payable to Affiliates | 36,981,317 | 37,093,776 |
| Total Liabilities | 1,473,976,196 | 1,406,562,148 |
| Commitments and Contingencies | | |
| Stockholders' Equity | | |
| Preferred Stock, \$1 par value | | |

Edgar Filing: ALFA CORP - Form 10-Q

Shares authorized: 1,000,000

Issued: None

| | | |
|-----------------------------|------------|------------|
| Common Stock, \$1 par value | 83,783,024 | 83,783,024 |
|-----------------------------|------------|------------|

Shares authorized: 110,000,000

Issued: 83,783,024

Outstanding: 2004 - 80,014,751; 2003 - 80,217,316

| | | |
|--------------------------------|------------|-----------|
| Capital in Excess of Par Value | 10,761,410 | 8,864,064 |
|--------------------------------|------------|-----------|

| | | |
|--|------------|------------|
| Accumulated Other Comprehensive Income | 24,202,424 | 41,351,404 |
|--|------------|------------|

| | | |
|-------------------|-------------|-------------|
| Retained Earnings | 570,646,892 | 537,746,631 |
|-------------------|-------------|-------------|

| | | |
|--|--------------|--------------|
| Treasury Stock: at cost (2004 - 3,768,273 shares; 2003 - 3,565,708 shares) | (37,707,712) | (33,232,685) |
|--|--------------|--------------|

| | | |
|----------------------------|-------------|-------------|
| Total Stockholders' Equity | 651,686,038 | 638,512,438 |
|----------------------------|-------------|-------------|

| | | |
|--|------------------|------------------|
| Total Liabilities and Stockholders' Equity | \$ 2,125,662,234 | \$ 2,045,074,586 |
|--|------------------|------------------|

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ALFA CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

| | Six Months Ended | | Three Months Ended | |
|---|----------------------|----------------------|----------------------|----------------------|
| | June 30, | | June 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Revenues | | | | |
| Premiums - Property and Casualty Insurance | \$ 242,271,552 | \$ 225,328,837 | \$ 122,328,952 | \$ 113,852,038 |
| Premiums - Life Insurance | 18,568,127 | 17,148,268 | 8,421,189 | 8,153,768 |
| Policy Charges - Life Insurance | 17,442,480 | 16,555,644 | 8,452,283 | 7,839,604 |
| Net Investment Income | 44,695,928 | 42,991,227 | 22,673,259 | 21,337,240 |
| Realized Investment Gains | 3,387,543 | 1,366,143 | 1,930,194 | 3,162,003 |
| Other Income | 820,262 | 1,350,196 | 261,387 | 754,566 |
| Total Revenues | 327,185,892 | 304,740,315 | 164,067,264 | 155,099,219 |
| Benefits and Expenses | | | | |
| Benefits & Settlement Expenses | 191,465,728 | 180,111,477 | 100,970,617 | 92,139,705 |
| Dividends to Policyholders | 1,962,954 | 1,937,883 | 920,229 | 915,370 |
| Amortization of Deferred Policy Acquisition Costs | 46,274,103 | 42,664,143 | 23,368,803 | 21,517,754 |
| Other Operating Expenses | 23,846,985 | 27,622,864 | 11,032,718 | 13,734,586 |
| Total Expenses | 263,549,770 | 252,336,367 | 136,292,367 | 128,307,415 |
| Income Before Provision for Income Taxes | 63,636,122 | 52,403,948 | 27,774,897 | 26,791,804 |
| Provision for Income Taxes | 17,593,104 | 14,486,499 | 7,208,766 | 7,603,983 |
| Net Income | \$ 46,043,018 | \$ 37,917,449 | \$ 20,566,131 | \$ 19,187,821 |
| Earnings Per Share: | | | | |
| Net Income | | | | |
| - Basic | \$ 0.58 | \$ 0.48 | \$ 0.26 | \$ 0.24 |
| - Diluted | \$ 0.57 | \$ 0.47 | \$ 0.26 | \$ 0.24 |
| Average Shares Outstanding | | | | |
| - Basic | 80,068,036 | 79,468,821 | 80,039,000 | 79,605,514 |
| - Diluted | 80,590,799 | 80,065,414 | 80,531,351 | 80,226,873 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ALFA CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| | Six Months Ended | | Three Months Ended | |
|---|------------------|---------------|--------------------|---------------|
| | June 30, | | June 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Net Income | \$ 46,043,018 | \$ 37,917,449 | \$ 20,566,131 | \$ 19,187,821 |
| Other Comprehensive (Loss) Income, net of tax: | | | | |
| Change in Fair Value of Securities Available for Sale | (17,036,505) | 5,006,235 | (28,078,762) | 6,212,523 |
| Unrealized Gains (Losses) on Interest Rate Swap Contracts | 2,089,428 | (2,302,735) | 3,057,482 | (1,503,316) |
| Less: Reclassification Adjustment for Realized Investment Gains | 2,201,903 | 887,993 | 1,254,626 | 2,055,302 |
| Total Other Comprehensive (Loss) Income | (17,148,980) | 1,815,507 | (26,275,906) | 2,653,905 |
| Total Comprehensive (Loss) Income | \$ 28,894,038 | \$ 39,732,956 | \$ (5,709,775) | \$ 21,841,726 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ALFA CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Six Months Ended June 30, | |
|---|---------------------------|---------------|
| | 2004 | 2003 |
| Cash Flows From Operating Activities: | | |
| Net Income | \$ 46,043,018 | \$ 37,917,449 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Policy Acquisition Costs Deferred | (53,933,135) | (49,937,531) |
| Amortization of Deferred Policy Acquisition Costs | 46,274,103 | 42,664,143 |
| Depreciation and Amortization | 1,475,946 | 181,603 |
| Provision for Deferred Taxes | 1,273,377 | 1,060,833 |
| Interest Credited on Policyholders Funds | 13,669,418 | 13,368,877 |
| Net Realized Investment (Gains) | (3,387,551) | (1,365,981) |
| Other | (1,240,737) | (4,675,967) |
| Changes in Operating Assets and Liabilities: | | |
| Accrued Investment Income | (432,627) | 949,900 |
| Accounts Receivable | (6,317,629) | 3,965,721 |
| Reinsurance Balances Receivable | 314,135 | (755,641) |
| Due from Affiliates | (369,763) | 2,533,951 |
| Other Assets | (810,977) | (3,066,897) |
| Liability for Policy Reserves | 5,049,090 | 4,197,484 |
| Liability for Unearned Premiums | 13,919,552 | 13,580,172 |
| Amounts Held for Others | (62,356) | 2,892 |
| Other Liabilities | (1,940,581) | 7,824,134 |
| Net Cash Provided by Operating Activities | 59,523,283 | 68,445,142 |
| Cash Flows from Investing Activities: | | |
| Maturities and Redemptions of Fixed Maturities Held for Investment | 29,011 | 80,764 |
| Maturities and Redemptions of Fixed Maturities Available for Sale | 181,452,775 | 354,904,442 |
| Maturities and Redemptions of Other Investments | 1,384,099 | 1,619,680 |
| Sales of Fixed Maturities Available for Sale | 11,828,510 | 24,684,645 |
| Sales of Equity Securities | 93,262,943 | 62,940,143 |
| Sales of Other Investments | 792,825 | 1,175,130 |
| Purchases of Fixed Maturities Available for Sale | (347,262,984) | (315,894,850) |
| Purchases of Equity Securities | (61,409,822) | (105,680,045) |
| Purchases of Other Investments | (17,328,490) | (8,998,950) |
| Origination of Consumer Loans Receivable | (30,389,510) | (29,588,170) |
| Principal Payments on Consumer Loans Receivable | 24,689,450 | 25,780,356 |
| Origination of Commercial Leases Receivable | (61,080,444) | (23,925,133) |
| Principal Payments on Commercial Leases Receivable | 31,367,295 | 23,399,604 |
| Net Change in Short-term Investments | 71,445,239 | (94,208,275) |
| Net Change in Receivable/Payable on Securities | 3,344,972 | 3,091,037 |
| Net Proceeds from Sales of Subsidiaries | 7,495,925 | |
| Net Cash Used in Investing Activities | (90,378,206) | (80,619,622) |

Edgar Filing: ALFA CORP - Form 10-Q

| | | |
|---|----------------------|----------------------|
| Cash Flows From Financing Activities: | | |
| Change in Commercial Paper | 29,061,185 | 3,076,463 |
| Change in Notes Payable to Affiliates | 2,237,541 | 3,071,054 |
| Stockholder Dividends Paid | (13,142,757) | (12,333,277) |
| Purchases of Treasury Stock | (7,620,611) | (2,338,268) |
| Proceeds from Exercise of Stock Options | 2,400,600 | 1,225,189 |
| Proceeds from Dividend Reinvestment Plan | | 6,983,033 |
| Deposits of Policyholders Funds | 43,998,826 | 46,294,539 |
| Withdrawal of Policyholders Funds | (26,492,047) | (24,857,055) |
| | <u>30,442,737</u> | <u>21,121,678</u> |
| Net Cash Provided by Financing Activities | 30,442,737 | 21,121,678 |
| | <u>(412,186)</u> | <u>8,947,198</u> |
| Net Change in Cash | (412,186) | 8,947,198 |
| Cash - Beginning of Period | 10,892,516 | 9,761,820 |
| | <u>10,480,330</u> | <u>18,709,018</u> |
| Cash - End of Period | \$ 10,480,330 | \$ 18,709,018 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash Paid During the Period for: | | |
| Interest | \$ 3,163,433 | \$ 3,383,959 |
| Income Taxes | \$ 23,105,561 | \$ 15,741,450 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**ALFA CORPORATION****NOTES TO CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS****June 30, 2004****1. Significant Accounting Policies**

In the opinion of the Company, the accompanying consolidated unaudited financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly its financial position, results of operations and cash flows. The accompanying financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America. A summary of the more significant accounting policies related to the Company's business is set forth in the notes to its audited consolidated financial statements for the fiscal year ended December 31, 2003. The results of operations for the six-month and three-month periods ended June 30, 2004 are not necessarily indicative of the results to be expected for the full year. Certain reclassifications have been made to conform previous classifications to June 30, 2004 classifications and descriptions.

The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all related amendments can be found at www.alfains.com by first selecting "Invest in Alfa" and then selecting "Financial Reports."

2. Stock-Based Employee Compensation

At June 30, 2004, the Company has a stock-based employee compensation plan, which is described more fully in the notes to the Company's audited consolidated financial statements for the fiscal year ended December 31, 2003. The Company accounts for this plan using the recognition and measurement principles of the intrinsic value method. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|---|----------------------------------|---------------|------------------------------------|---------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net income as reported | \$ 46,043,018 | \$ 37,917,449 | \$ 20,566,131 | \$ 19,187,821 |
| Add: Total stock-based compensation expense included in reported net income, net of tax effect | 33,011 | 40,507 | 32,312 | 15,851 |
| Less: Total stock-based compensation expense determined under fair value based method for all awards, net of tax effect | (978,524) | (744,637) | (524,388) | (381,544) |
| Pro forma net income | \$ 45,097,505 | \$ 37,213,319 | \$ 20,074,055 | \$ 18,822,128 |
| Earnings per share, as reported - Basic | \$ 0.58 | \$ 0.48 | \$ 0.26 | \$ 0.24 |
| - Diluted | \$ 0.57 | \$ 0.47 | \$ 0.26 | \$ 0.24 |

Edgar Filing: ALFA CORP - Form 10-Q

| | | | | |
|--------------------------------------|---------|---------|---------|---------|
| Pro forma earnings per share - Basic | \$ 0.56 | \$ 0.47 | \$ 0.25 | \$ 0.24 |
| - Diluted | \$ 0.56 | \$ 0.46 | \$ 0.25 | \$ 0.23 |

Table of Contents**3. Pooling Agreement**

Effective August 1, 1987, the Company entered into a property and casualty insurance Pooling Agreement (the "Pooling Agreement") with Alfa Mutual Insurance Company (Mutual), and other members of the Mutual Group (See Note 4). On January 1, 2001, Alfa Specialty Insurance Corporation (Specialty), a subsidiary of Mutual, also became a participant in the Pooling Agreement. The Mutual Group is a direct writer primarily of personal lines of property and casualty insurance in Alabama. The Company's subsidiaries similarly are direct writers in Georgia and Mississippi. Both the Mutual Group and the Company write preferred risk automobile, homeowner, farmowner and mobile home insurance, fire and allied lines, standard risk automobile and homeowner insurance, and a limited amount of commercial insurance, including church and businessowner insurance. Specialty is a direct writer primarily of nonstandard risk automobile insurance. Under the terms of the Pooling Agreement, the Company cedes to Mutual all of its property and casualty business. Substantially all of the Mutual Group's direct property and casualty business (together with the property and casualty business ceded by the Company) is included in the pool. Mutual currently retrocedes 65% of the pool to the Company and retains 35% within the Mutual Group. Effective January 1, 2001, Specialty's property and casualty business likewise became included in the pool. On October 1, 1996, the Pooling Agreement was amended in conjunction with the restructuring of the Alfa Insurance Group's catastrophe protection program. Effective November 1, 1996, the allocation of catastrophe costs among the members of the pool was changed to better reflect the economics of catastrophe finance. The amendment limited Alfa Corporation's participation in any single catastrophic event or series of storms to its pool share (65%) of a lower catastrophe pool limit unless the loss exceeded an upper catastrophe pool limit. In cases where the upper catastrophe limit is exceeded on a 100% basis, the Company's share in the loss would be based upon its amount of surplus relative to other members of the group. Lower and upper catastrophe pool limits are adjusted periodically due to increases in insured property risks. The limits and participation levels since inception of the program are summarized below:

| | Lower Catastrophe Pool Limit (millions) | Upper Catastrophe Pool Limit (millions) | Estimated Coinsurance Allocation of Catastrophes Exceeding Upper Catastrophe Pool Limit |
|------------------|--|--|--|
| November 1, 1996 | \$ 10.0 | \$ 249.0 | 13% |
| July 1, 1999 | 11.0 | 284.0 | 13% |
| January 1, 2001 | 11.4 | 284.0 | 14% |
| January 1, 2002 | 11.6 | 289.0 | 16% |
| January 1, 2003 | 12.1 | 301.5 | 18% |
| January 1, 2004 | 14.2 | 352.0 | 18% |

The Company's participation in the Pooling Agreement may be changed or terminated without the consent or approval of the Company's shareholders. The Pooling Agreement may be terminated only by mutual agreement of the parties in writing.

Table of Contents

(Note 3., continued)

The following table sets forth the premiums and losses ceded to and assumed from the pool for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|----------------------------|----------------------------------|-------------|------------------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| Premiums ceded to pool | \$ 47,260 | \$ 42,522 | \$ 23,981 | \$ 21,527 |
| Premiums assumed from pool | \$ 241,152 | \$ 224,061 | \$ 121,791 | \$ 113,225 |
| Losses ceded to pool | \$ 29,001 | \$ 33,424 | \$ 14,945 | \$ 19,466 |
| Losses assumed from pool | \$ 145,492 | \$ 139,986 | \$ 76,922 | \$ 72,761 |

The Company incurred \$9.2 million and \$7.9 million in storm losses in the second quarters of 2004 and 2003, respectively. These losses resulted in reductions to the Company's net income of approximately \$0.07 and \$0.06 per diluted share, after reinsurance and taxes, in 2004 and 2003, respectively. No catastrophe losses were incurred in the first quarter of either year.

4. Contingent Liabilities

The property and casualty subsidiaries have entered into the reinsurance pooling agreement with Alfa Mutual Insurance Company and its affiliates as discussed in Note 3. Should any member of the affiliated group be unable to meet its obligation on a claim for a policy written by the Company's property and casualty subsidiaries, the obligation to pay the claim would remain with the Company's subsidiaries.

The liability for estimated unpaid property and casualty losses and loss adjustment expenses is based on a detailed evaluation of reported losses and estimates of incurred but not reported losses. Adjustments to the liability based upon subsequent developments are included in current operations.

Certain legal proceedings are in process at June 30, 2004. Costs for these and similar legal proceedings, including accruals for outstanding cases, totaled \$161,000 in the first six months of 2004, \$1.1 million in 2003, and \$5.3 million in 2002. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims, and miscellaneous other causes of action. These lawsuits involve claims for unspecified amounts of compensatory damages, mental anguish damages, and punitive damages.

Approximately 20 legal proceedings against Alfa Life Insurance Corporation (Life) were in process at June 30, 2004. Of the 20 proceedings, seven were filed in 2004, eight were filed in 2003, one was filed in 2002, three were filed in 1999, and one was filed in 1996. One of the 20 pending cases was filed as a purported class action, but no class has been certified. In a case tried in January 2001, in Barbour County, Alabama, the jury returned a verdict for the plaintiff against Life for \$500,000 in compensatory damages and \$5,000,000 in punitive damages. After Life filed post-trial motions, the trial court reduced the punitive damage award to \$1,500,000. On appeal, the Alabama Supreme Court further reduced the total judgment to \$400,000. Life has filed an Application for Rehearing with the Court seeking a further reduction of the award.

Edgar Filing: ALFA CORP - Form 10-Q

In addition, one purported class action lawsuit is pending against both Alfa Builders, Inc. and Alfa Mutual Fire Insurance Company. Additionally, three purported class action lawsuits are pending against the property

Table of Contents

(Note 4., continued)

and casualty companies involving a number of issues and allegations which could affect the Company because of a pooling agreement between the companies. No class has been certified in any of these four purported class action cases. In the event a class is certified in any of these purported class actions, reserves may need to be adjusted.

Management believes adequate accruals have been established in these known cases. However, it should be noted that in Mississippi and Alabama, where the Company has substantial business, the likelihood of a judgment in any given suit, including a large mental anguish and/or punitive damage award by a jury, bearing little or no relation to actual damages, continues to exist, creating the potential for unpredictable material adverse financial results.

Based upon information presently available, unreserved contingent liabilities arising from any other threatened litigation are not presently considered by management to be material.

The Company periodically invests in partnerships that invest in affordable housing tax credits. At June 30, 2004, the Company had committed to fund partnerships of this type in the amount of approximately \$28.0 million.

Table of Contents**5. Segment Information**

In evaluating the performance of the Company's segments, management believes operating income serves as a meaningful tool for assessing the profitability of the Company's ongoing operations. Operating income, a non-GAAP financial measure, is defined by the Company as net income excluding net realized investment gains and losses, net of applicable taxes. Realized investment gains and losses are somewhat controllable by the Company through the timing of decisions to sell securities. Therefore, realized investment gains and losses are not indicative of future operating performance.

The table below summarizes net income by its components of operating income by segment, net realized gains and losses, and corporate expenses for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|--|---------------------------|------------|----------|-----------------------------|------------|----------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| (in thousands, except share and per share data) | | | | | | |
| Net income | | | | | | |
| Property and casualty insurance | \$ 34,809 | \$ 27,534 | 26% | \$ 15,380 | \$ 12,397 | 24% |
| Life insurance | 8,030 | 8,569 | (6)% | 3,558 | 4,653 | (24)% |
| Total insurance operations | 42,839 | 36,103 | 19% | 18,938 | 17,050 | 11% |
| Noninsurance operations income | 2,290 | 2,178 | 5% | 1,027 | 757 | 36% |
| Net realized investment gains | 2,202 | 888 | 148% | 1,255 | 2,056 | (39)% |
| Corporate expenses | (1,288) | (1,252) | 3% | (654) | (675) | (3)% |
| Net income | \$ 46,043 | \$ 37,917 | 21% | \$ 20,566 | \$ 19,188 | 7% |
| Net income per share- | | | | | | |
| Basic | \$ 0.58 | \$ 0.48 | 21% | \$ 0.26 | \$ 0.24 | 7% |
| Diluted | \$ 0.57 | \$ 0.47 | 21% | \$ 0.26 | \$ 0.24 | 7% |
| Weighted average shares outstanding - Basic | | | | | | |
| | 80,068,036 | 79,468,821 | | 80,039,000 | 79,605,514 | |
| Diluted | 80,590,799 | 80,065,414 | | 80,531,351 | 80,226,873 | |

Table of Contents

(Note 5., continued)

The following table sets forth the components of property and casualty insurance earned premiums, net underwriting income, GAAP basis loss, expense and combined ratios, underwriting margin, net investment income, other income, reinsurance assumed, operating income, net realized investment gains and net income for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|---------------------------------------|---------------------------|------------|----------|-----------------------------|------------|----------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| | (in thousands) | | | | | |
| Earned premiums | | | | | | |
| Personal lines | \$ 233,224 | \$ 216,530 | 8% | \$ 117,808 | \$ 109,676 | 7% |
| Commercial lines | 7,929 | 7,531 | 5% | 3,983 | 3,548 | 12% |
| Pools, associations and fees | 2,406 | 2,363 | 2% | 1,192 | 1,182 | 1% |
| Reinsurance ceded | (1,287) | (1,095) | (18)% | (654) | (554) | (18)% |
| Total | \$ 242,272 | \$ 225,329 | 8% | \$ 122,329 | \$ 113,852 | 7% |
| Net underwriting income | \$ 31,632 | \$ 22,454 | 41% | \$ 12,394 | \$ 9,124 | 36% |
| Loss ratio | 60.2% | 61.6% | | 63.3% | 63.4% | |
| LAE ratio | 3.9% | 3.9% | | 4.0% | 3.9% | |
| Expense ratio | 22.8% | 24.5% | | 22.6% | 24.7% | |
| GAAP basis combined ratio | 86.9% | 90.0% | | 89.9% | 92.0% | |
| Underwriting margin | 13.1% | 10.0% | | 10.1% | 8.0% | |
| Net investment income | \$ 14,952 | \$ 14,564 | 3% | \$ 7,530 | \$ 7,654 | (2)% |
| Other income | \$ 156 | \$ 100 | 56% | \$ 31 | \$ 24 | 29% |
| Reinsurance assumed | \$ 9 | \$ (28) | 132% | \$ (5) | \$ 5 | (182)% |
| Pre-tax operating income | \$ 46,749 | \$ 37,083 | 26% | \$ 19,950 | \$ 16,807 | 19% |
| Operating income, net of tax | \$ 34,809 | \$ 27,534 | 26% | \$ 15,380 | \$ 12,397 | 24% |
| Realized investment gains, net of tax | \$ 65 | \$ 315 | (79)% | \$ 76 | \$ 682 | (89)% |
| Net income | \$ 34,874 | \$ 27,849 | 25% | \$ 15,456 | \$ 13,079 | 18% |

Table of Contents

(Note 5., continued)

The following table sets forth life insurance premiums and policy charges, by type of policy, net investment income, benefits and expenses, amortization of deferred policy acquisition costs, life insurance operating income, net realized investment gains and losses, and net income for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|---|---------------------------|-----------|----------|-----------------------------|-----------|----------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| | (in thousands) | | | | | |
| Premiums and policy charges | | | | | | |
| Universal life policy charges | \$ 9,877 | \$ 9,355 | 6% | \$ 4,982 | \$ 4,733 | 5% |
| Universal life policy charges - COLI | 2,160 | 2,085 | 4% | 656 | 575 | 14% |
| Interest sensitive life policy charges | 5,406 | 5,115 | 6% | 2,814 | 2,532 | 11% |
| Traditional life insurance premiums | 18,076 | 16,607 | 9% | 8,421 | 8,327 | 1% |
| Group life insurance premiums | 492 | 542 | (9)% | 0 | (174) | 100% |
| Total | \$ 36,011 | \$ 33,704 | 7% | \$ 16,873 | \$ 15,993 | 6% |
| Net investment income | \$ 23,535 | \$ 22,483 | 5% | \$ 12,071 | \$ 10,948 | 10% |
| Benefits and expenses | \$ 43,980 | \$ 39,910 | 10% | \$ 21,788 | \$ 18,599 | 17% |
| Amortization of deferred policy acquisition costs | \$ 4,584 | \$ 4,575 | 0% | \$ 2,275 | \$ 2,270 | 0% |
| Pre-tax operating income | \$ 10,982 | \$ 11,702 | (6)% | \$ 4,881 | \$ 6,072 | (20)% |
| Operating income, net of tax | \$ 8,030 | \$ 8,569 | (6)% | \$ 3,558 | \$ 4,653 | (24)% |
| Realized investment gains, net of tax | \$ 2,289 | \$ 596 | 284% | \$ 1,179 | \$ 1,396 | (16)% |
| Net income | \$ 10,319 | \$ 9,165 | 13% | \$ 4,737 | \$ 6,049 | (22)% |

6. Note Payable and Interest Rate Swap Contract

The Company uses variable-rate debt to partially fund its consumer loan and commercial lease portfolios. In particular, it has issued variable-rate long-term debt and commercial paper. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense also decreases.

Edgar Filing: ALFA CORP - Form 10-Q

As part of its funding efforts, the Company issued a \$70 million variable-rate long-term obligation with a life of fifteen years in the second quarter of 2002. Management believes it is prudent to limit the variability of a portion of its interest payments. The Company's objective is to hedge 100 percent of its variable-rate long-term interest payments over the first five years of the life of the debt obligation.

Table of Contents

(Note 6., continued)

To meet this objective, management entered into an interest rate swap. The interest rate swap changes the variable-rate cash flow exposure of the variable-rate long term debt obligation to fixed-rate cash flows by entering into a receive-variable, pay-fixed interest rate swap. Under the interest rate swap, the Company receives variable interest payments and makes fixed interest rate payments, thereby creating fixed-rate long-term debt and, therefore, managing fluctuations in cash flows resulting from interest rate risk.

The Company also uses derivative instruments through its covered call option program as a means of generating income.

The Company assesses interest rate cash flow risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities.

The Company maintains risk management control systems to monitor interest rate cash flow risk attributable to both the Company's outstanding or forecasted debt obligations as well as the Company's offsetting hedge position. The risk management control systems involve the use of analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on the Company's future cash flows.

Interest expense for the six months ended June 30, 2004 includes no gains or losses from the interest rate swap. Changes in fair value of the interest rate swap designated as a hedging instrument of the variability of cash flows associated with floating-rate, long-term debt obligation are reported in accumulated other comprehensive income. The interest rate swap involves a LIBOR for LIBOR exchange and meets the criteria for short-cut accounting. Therefore, the interest rate swap has no ineffectiveness, thereby eliminating the reclassification of this amount to interest expense in subsequent periods.

7. Financial Accounting Developments

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of FASB Statement No. 123. While the Company continues to use the intrinsic value method to account for its stock options, notes contained in this filing for the six-month and three-month periods ended June 30, 2004 have been enhanced to comply with the requirements set forth by this statement.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities. This interpretation addresses consolidation and disclosure issues associated with variable interest entities. The effective date for the interpretation has been delayed to December 31, 2003 on those variable interest entities in existence prior to February 1, 2003. The Company has evaluated the provisions of this interpretation and its requirements had no significant impact on the Company's financial position or income.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. The changes in this statement improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. These changes

Edgar Filing: ALFA CORP - Form 10-Q

will result in more consistent reporting of contracts as either derivatives or hybrid instruments. This statement is effective for contracts entered into or modified after June 30, 2004 and for hedging relationships designated after June 30, 2004. At this time, the Company does not anticipate this standard having a significant impact on the Company's financial position or income.

Table of Contents

(Note. 7., continued)

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and is effective for financial instruments entered into or modified after May 31, 2003. The Company did not experience a significant impact on the Company's financial position or income from this statement.

In July 2003, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts for Separate Accounts. This SOP became effective for fiscal years beginning after December 15, 2003. The new rule changes accounting for separate accounts and sales inducements and changes the liability model by expanding the definition of account balance and addressing annuitization guarantees and minimum guaranteed death benefits. The Company has implemented this SOP effective January 1, 2004 and it did not have a significant impact on its financial position or income.

8. Dissolution of Alfa Investment Corporation

On April 24, 2003, the Company's Board of Directors approved a written consent to dissolve Alfa Investment Corporation. The Company was the only stockholder of this entity which was consolidated in its financial statements. Alfa Investment Corporation had served as the parent of Alfa Builders, Inc. which continued to operate as the Company's wholly-owned construction subsidiary until it was sold in February 2004.

9. Sales of Alfa Builders, Inc. and Alfa Realty, Inc.

During 2003, MidCountry Financial Corporation, one of the investments of the Company's finance subsidiary, pursued the opportunity to purchase Bayside Financial Corp. In order for this purchase to take place, approval had to be secured from the Office of Thrift Supervision. Consequently, due to ownership levels, this transaction qualified the finance subsidiary and the Company as unitary thrift holding companies. As a condition of approval, the Company agreed to sell its residential and commercial construction subsidiary and its real estate sales subsidiary. These sales took place during the first quarter of 2004 as Southern Boulevard Corporation, the real estate subsidiary of Mutual purchased Alfa Builders, Inc. and Alfa Realty, Inc. for approximately \$5.5 million and \$2.6 million respectively. These sales prices represented the fair value of each entity according to independent valuations. No gain or loss was recorded on these transactions.

Table of Contents

10. Subsequent Event

A customer of the Company's commercial leasing operations, NorVergence, filed for Chapter 7 bankruptcy status on July 15, 2004. As a telecommunications provider, NorVergence supplied essential services to 341 of the Company's leasing customers. During July, the Company did see an increase in delinquencies from the affected customers but has not presently determined the potential impact this bankruptcy action may have on the \$7.7 million in leasing receivables OFC Capital held with its customers at June 30, 2004. As of July 30, 2004, all of these lease customers were current on their lease obligations to the Company. NorVergence owed \$123,363 for net leasing obligations at June 30, 2004 for which the Company has fully reserved within its second quarter results. The Company also chose to fully reserve for amounts placed back to NorVergence under first payment default clauses on leases with OFC Capital in the amount of \$129,835. The Company will continue to monitor the potential impairment of these leases. As a service to its customers, the Company is assisting them with securing a replacement telecommunications provider and has also reserved \$511,500 for potential expenses it may incur during the third quarter of 2004 in this effort.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

Alfa Corporation:

We have reviewed the accompanying consolidated balance sheets of Alfa Corporation and subsidiaries as of June 30, 2004 and 2003, the related consolidated statements of income and comprehensive income for the six-months and three-months ended June 30, 2004 and 2003, and the related consolidated statements of cash flows for the six-months ended June 30, 2004 and 2003. These consolidated financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Birmingham, Alabama

July 21, 2004

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

Management's Discussion and Analysis is intended to update the reader on matters affecting the financial condition and results of operations of Alfa Corporation and its subsidiaries for the six-month and three-month periods ended June 30, 2004 and 2003. As a result, the following discussion should be read in conjunction with the consolidated financial statements and notes that are included in this 10-Q and in the annual report to stockholders for the year ended December 31, 2003.

The Company is a financial services holding company affiliated with the Alfa Mutual Insurance Companies, which own 55.1% of the Company's common stock. The Company's primary business is personal lines of property and casualty insurance and life insurance. At June 30, 2004, it also had noninsurance subsidiaries that engaged in consumer financing and commercial leasing. The Company and its subsidiaries together with the Alfa Mutual Insurance Companies currently service approximately 1.3 million policyholders primarily in Alabama, Georgia and Mississippi.

The Company's revenue consists mainly of premiums earned, policy charges and net investment income. Benefit and settlement expenses consist primarily of claims paid and claims in process and pending and include an estimate of amounts incurred but not yet reported along with loss adjustment expenses. Other operating expenses consist primarily of compensation expenses and other overhead business expenses.

Operating results are reported through three primary business segments: property and casualty insurance operations, life insurance operations and noninsurance operations. Property and casualty insurance operations accounted for 78.7% of revenues and 75.7% of net income in the first six months of 2004. Life insurance operations generated 19.3% of revenues and 22.4% of net income during the same period.

Future results of operations will depend in part on the Company's ability to predict and control benefit and settlement expenses through underwriting criteria, product design and negotiation of favorable vendor contracts. The Company must also seek timely and accurate rate changes from insurance regulators in order to meet strategic business objectives. Selection of insurable risks, proper collateralization of loans and leases and continued staff development also impact the operating results of the Company. The Company's inability to mitigate any or all risks mentioned above or other factors may adversely affect its profitability.

In evaluating the performance of the Company's segments, management believes operating income serves as a meaningful tool for assessing the profitability of the Company's ongoing operations. Operating income, a non-GAAP financial measure, is defined by the Company as net income excluding net realized investment gains and losses, net of applicable taxes. Realized investment gains and losses are somewhat controllable by the Company through the timing of decisions to sell securities. Therefore, realized investment gains and losses are not indicative of future operating performance.

Table of Contents

The following table sets forth consolidated summarized income statement information for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|---|---------------------------|------------|----------|-----------------------------|------------|----------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| | (in thousands) | | | | | |
| Revenues | | | | | | |
| Property and casualty insurance premiums | \$ 242,272 | \$ 225,329 | 8% | \$ 122,329 | \$ 113,852 | 7% |
| Life insurance premiums and policy charges | 36,011 | 33,704 | 7% | 16,873 | 15,993 | 6% |
| Total premiums and policy charges | \$ 278,283 | \$ 259,033 | 7% | \$ 139,202 | \$ 129,845 | 7% |
| Net investment income | \$ 44,695 | \$ 42,991 | 4% | \$ 22,673 | \$ 21,337 | 6% |
| Total revenues | \$ 327,186 | \$ 304,740 | 7% | \$ 164,067 | \$ 155,099 | 6% |
| Net income | | | | | | |
| Property and casualty insurance | \$ 34,809 | \$ 27,534 | 26% | \$ 15,380 | \$ 12,397 | 24% |
| Life insurance | 8,030 | 8,569 | (6)% | 3,558 | 4,653 | (24)% |
| Total insurance operations | 42,839 | 36,103 | 19% | 18,938 | 17,050 | 11% |
| Noninsurance operations | 2,290 | 2,178 | 5% | 1,027 | 757 | 36% |
| Net realized investment gains | 2,202 | 888 | 148% | 1,255 | 2,056 | (39)% |
| Corporate expenses | (1,288) | (1,252) | 3% | (654) | (675) | (3)% |
| Net income | \$ 46,043 | \$ 37,917 | 21% | \$ 20,566 | \$ 19,188 | 7% |
| Net income per share- | | | | | | |
| Basic | \$ 0.58 | \$ 0.48 | 21% | \$ 0.26 | \$ 0.24 | 7% |
| Diluted | \$ 0.57 | \$ 0.47 | 21% | \$ 0.26 | \$ 0.24 | 7% |
| Weighted average shares outstanding - Basic | | | | | | |
| | 80,068,036 | 79,468,821 | | 80,039,000 | 79,605,514 | |
| Diluted | 80,590,799 | 80,065,414 | | 80,531,351 | 80,226,873 | |

Total premiums and policy charges increased 7% in the first six months of 2004 as a result of increased premium production in both property casualty and life business and continued good persistency. Net investment income increased 4% in the first six months of 2004 and invested assets grew 3.6% in the six months since December 31, 2003.

Edgar Filing: ALFA CORP - Form 10-Q

Operating income increased by 26% in the property casualty subsidiaries due primarily to an improved loss ratio and reduction in the underwriting expense ratio during the first six months of 2004. The 6% decrease in operating income in the life subsidiary is partially due to a higher mortality ratio of 103% compared to 96% during the first six months of 2003. Mortality, a non-GAAP financial measure used by management, represents

Table of Contents

the percentage of actuarially expected claims paid. Therefore, in the first six months of 2004, the Company experienced more unfavorable financial results when compared to 2003 due to the higher mortality ratio. Noninsurance operations were up 5% due to earnings increases in the finance and benefit subsidiaries. Earnings from the finance subsidiary's investment in MidCountry Financial decreased by approximately \$77,000 when compared to the first six months of 2003. However, favorable results in the Company's commercial lease operations led to an overall increase in earnings of approximately \$275,000 by the finance subsidiary.

The Company's net income was positively impacted by realized investment gains during the first six months of 2004. Corporate expenses increased by 3% in the first six months of 2004 due primarily to increases in accounting fees.

Table of Contents**PROPERTY AND CASUALTY INSURANCE OPERATIONS**

The following table sets forth the components of property and casualty insurance earned premiums, net underwriting income, GAAP basis loss, expense and combined ratios, underwriting margin, net investment income, other income, reinsurance assumed, operating income, net realized investment gains and net income for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|---------------------------------------|---------------------------|------------|----------|-----------------------------|------------|----------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| | (in thousands) | | | | | |
| Earned Premiums | | | | | | |
| Personal lines | \$ 233,224 | \$ 216,530 | 8% | \$ 117,808 | \$ 109,676 | 7% |
| Commercial lines | 7,929 | 7,531 | 5% | 3,983 | 3,548 | 10% |
| Pools, associations and fees | 2,406 | 2,363 | 2% | 1,192 | 1,182 | 1% |
| Reinsurance | (1,287) | (1,095) | (18)% | (654) | (554) | (18)% |
| Total | \$ 242,272 | \$ 225,329 | 8% | \$ 122,329 | \$ 113,852 | 7% |
| Net underwriting income | \$ 31,632 | \$ 22,454 | 41% | \$ 12,394 | \$ 9,124 | 36% |
| Loss ratio | 60.2% | 61.6% | | 63.3% | 63.4% | |
| LAE ratio | 3.9% | 3.9% | | 4.0% | 3.9% | |
| Expense ratio | 22.8% | 24.5% | | 22.6% | 24.7% | |
| GAAP basis combined ratio | 86.9% | 90.0% | | 89.9% | 92.0% | |
| Underwriting margin | 13.1% | 10.0% | | 10.1% | 8.0% | |
| Net investment income | \$ 14,952 | \$ 14,564 | 3% | \$ 7,530 | \$ 7,654 | (2)% |
| Other income | \$ 156 | \$ 100 | 56% | \$ 31 | \$ 24 | 29% |
| Reinsurance assumed | \$ 9 | \$ (28) | 132% | \$ (5) | \$ 5 | (182)% |
| Pre-tax operating income | \$ 46,749 | \$ 37,083 | 26% | \$ 19,950 | \$ 16,807 | 19% |
| Operating income, net of tax | \$ 34,809 | \$ 27,534 | 26% | \$ 15,380 | \$ 12,397 | 24% |
| Realized investment gains, net of tax | \$ 65 | \$ 315 | (79)% | \$ 76 | \$ 682 | (89)% |
| Net income | \$ 34,874 | \$ 27,849 | 25% | \$ 15,456 | \$ 13,079 | 18% |

Table of Contents

Earned premiums increased 8% in the first six months of 2004 due to greater homeowner production and the positive impact of rate increases. Continued good persistency in the automobile and homeowner lines also contributed to premium increases.

The overall loss ratio decreased to 60.2% for the first six months of 2004 as the Company continued to experience favorable core loss ratios. The Company incurred \$9.2 million and \$7.9 million in storm losses in the second quarter of 2004 and 2003, respectively. No storm losses were recorded in the first quarters of either 2004 or 2003. Loss adjustment expenses in the first six months were 3.9% of earned premiums in both 2004 and 2003. In addition to the improvement in the Company's core loss ratio, a decrease in the expense ratio from 2003 levels resulting from stable compensation expenses contributed to the improved underwriting margin. The Company has implemented changes to its processes in an effort to minimize staffing additions and capitalize on technological capabilities.

Net investment income increased 3% in the first six months of 2004 in the property casualty subsidiaries due primarily to earnings on fixed maturities. Invested assets increased 2.2% since June 30, 2003.

LIFE INSURANCE OPERATIONS

The following table sets forth life insurance premiums and policy charges, by type of policy, net investment income, benefits and expenses, amortization of deferred policy acquisition costs, life insurance operating income, net realized investments gains and losses, and net income for the six-month and three-month periods ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | | | Three Months Ended June 30, | | |
|---|----------------------------------|------------------|-----------------|------------------------------------|------------------|-----------------|
| | 2004 | 2003 | % Change | 2004 | 2003 | % Change |
| | | | | | | |
| | (in thousands) | | | | | |
| Premiums and policy charges | | | | | | |
| Universal life policy charges | \$ 9,877 | \$ 9,355 | 6% | \$ 4,982 | \$ 4,733 | 5% |
| Universal life policy charges - COLI | 2,160 | 2,085 | 4% | 656 | 575 | 14% |
| Interest sensitive life policy charges | 5,406 | 5,115 | 6% | 2,814 | 2,532 | 11% |
| Traditional life insurance premiums | 18,076 | 16,607 | 9% | 8,421 | 8,327 | 1% |
| Group life insurance premiums | 492 | 542 | (9)% | 0 | (174) | 100% |
| Total | \$ 36,011 | \$ 33,704 | 7% | \$ 16,873 | \$ 15,993 | 6% |
| Net investment income | \$ 23,535 | \$ 22,483 | 5% | \$ 12,071 | \$ 10,948 | 10% |
| Benefits and expenses | \$ 43,980 | \$ 39,910 | 10% | \$ 21,788 | \$ 18,599 | 17% |
| Amortization of deferred policy acquisition costs | \$ 4,584 | \$ 4,575 | 0% | \$ 2,275 | \$ 2,270 | 0% |
| Pre-tax operating income | \$ 10,982 | \$ 11,702 | (6)% | \$ 4,881 | \$ 6,072 | (20)% |
| Operating income, net of tax | \$ 8,030 | \$ 8,569 | (6)% | \$ 3,558 | \$ 4,653 | (24)% |

Edgar Filing: ALFA CORP - Form 10-Q

| Realized investment gains/ (losses), net of tax | \$ 2,289 | \$ 596 | 284% | \$ 1,179 | \$ 1,396 | (16)% |
|---|-----------|----------|------|----------|----------|-------|
| Net income | \$ 10,319 | \$ 9,165 | 13% | \$ 4,737 | \$ 6,049 | (22)% |

Table of Contents

The Company's life insurance premiums and policy charges increased 7% in the first six months of 2004 due to strong persistency and new business resulting from the introduction of revised life products featuring preferred underwriting classes and lower premium rates. First year collected premiums in the first six months of 2004 declined 3% from the same period in 2003 despite strong sales of term products. Total new annualized premium increased 4.2% in the first six months of 2004 after decreasing 3.4% in all of 2003.

Life insurance operating income decreased approximately 6% in the first six months of 2004. This decrease was primarily the result of an increase in the mortality ratio of actual to expected death claims from 96% in the first six months of 2003 to 103% in the first six months of 2004. Positive cash flows resulted in a 4.1% increase in invested assets since June 30, 2003 while investment income increased 5% from the first six months of 2003.

NONINSURANCE OPERATIONS

Noninsurance operations were up 5% due primarily to more favorable results in the finance and benefit subsidiaries. The finance subsidiary's investment in MidCountry Financial yielded pre-tax income of approximately \$434,000 during the first six months of 2004 compared to \$552,000 in the first half of 2003. Overall, however, the finance subsidiary's operating income increased \$275,000 during the first six months of 2004 when compared to the same period in 2003 due to a decrease in legal expenses related to its commercial leasing operations. Income from the Company's subsidiary covering certain employee benefits increased by approximately \$76,000 to \$191,000 for the first six months in 2004. The sales of the Company's real estate and construction subsidiaries in February 2004 have created unfavorable earnings comparisons since these business units incurred losses of approximately \$47,000 prior to their dispositions in 2004 compared to earnings of approximately \$203,000 during the first six months of 2003.

CORPORATE

Corporate expenses increased 3%, or approximately \$36,000, due primarily to an increase in accounting fees. Favorable short-term interest rates and a reduction in the commercial paper borrowings attributable to corporate functions allowed the Company's interest expense to decline slightly from levels experienced in the first half of 2003.

INVESTMENTS

The Company has historically produced positive cash flow from operations which has resulted in increasing amounts of funds available for investment and, consequently, higher investment income. Investment income is also affected by yield rates. Information about cash flows, invested assets and yield rates is presented below for the six months ended June 30, 2004 and 2003:

| | Six Months Ended June 30, | |
|--|--------------------------------------|-------------|
| | 2004 | 2003 |
| Increase in invested assets since January 1, 2004 and 2003 | 3.6% | 6.3% |

Edgar Filing: ALFA CORP - Form 10-Q

| | | |
|---|------|--------|
| Investment yield rate (annualized) | 5.7% | 5.9% |
| Increase/(decrease) in net investment income since June 30, 2003 and 2002 | 4.0% | (2.2)% |

Table of Contents

As a result of the overall positive cash flows from operations, invested assets grew 3.6% since January 1, 2004 and 5.4% since June 30, 2003 (based on amortized cost, which excludes the impact of SFAS 115) while net investment income increased 4.0%. The positive cash flow from operations is due primarily to the improved operating results in the Company's property and casualty subsidiaries, which had \$31.6 million in underwriting income in the first six months of 2004 which was somewhat offset by the slight decline in profitability of the Company's life subsidiary, which had \$8.6 million in operating income in the same period. The premium collection from the COLI plan in the life insurance subsidiary provided positive cash flow in the first quarter of both periods. Net increases in cash resulting from increased borrowings were primarily used to support growth in the loan and lease portfolios of the finance subsidiary. During the first six months of 2004, the Company also increased its investment in debt securities by approximately \$121 million. The Company's increase in net investment income resulted primarily from earnings on fixed maturities. The overall yield rate, calculated using amortized cost, declined to 5.7%. The Company had net realized investment gains of approximately \$2.2 million in the first six months of 2004 compared to net realized investment gains of approximately \$888,000 during the same period of 2003. These net gains are primarily from sales of equity securities. Such realized gains are the result of market conditions and therefore can fluctuate from period to period.

The composition of the Company's investment portfolio is as follows at June 30, 2004 and December 31, 2003:

| | June 30, | December 31, |
|-----------------------------|-----------------|---------------------|
| | 2004 | 2003 |
| | <hr/> | <hr/> |
| Fixed maturities | | |
| Taxable | | |
| Mortgage backed (CMO's) | 31.4% | 25.5% |
| Corporate bonds | 20.8 | 21.0 |
| | <hr/> | <hr/> |
| Total taxable | 52.2 | 46.5 |
| Tax exempts | 16.8 | 18.2 |
| | <hr/> | <hr/> |
| Total fixed maturities | 69.0 | 64.7 |
| | <hr/> | <hr/> |
| Equity securities | 5.7 | 7.5 |
| Real estate | 0.0 | 0.1 |
| Policy loans | 3.1 | 3.1 |
| Collateral loans | 5.8 | 5.7 |
| Commercial leases | 7.9 | 6.5 |
| Other long-term investments | 6.5 | 6.2 |
| Short-term investments | 2.0 | 6.2 |
| | <hr/> | <hr/> |
| | 100.0% | 100.0% |
| | <hr/> | <hr/> |

The majority of the Company's investment portfolio consists of fixed maturities which are diverse as to both industry and geographic concentration. Since year end, the overall mix of investments has remained relatively stable with changes due to a shift from short-term investments and equity securities to fixed maturities and commercial leases and to market value fluctuations in both fixed maturities and equity securities.

Table of Contents

The rating of the Company's portfolio of fixed maturities using the Standard & Poor's rating categories is as follows at June 30, 2004 and December 31, 2003:

| | June 30, 2004 | December 31, 2003 |
|--|------------------|----------------------|
| <u>RATING</u> | | |
| AAA to A- | 92.7 | 90.9% |
| BBB+ to BBB- | 6.9 | 8.4 |
| BB+ and Below (Below investment grade) | 0.4 | 0.7 |
| | 100.0% | 100.0% |

The fixed maturity portfolio was rated by an outside rating service. No securities were rated by Company management. The Company considers bonds with a quality rating of BB+ and below to be below investment grade or high yield bonds (also called junk bonds).

At June 30, 2004, approximately 45.5% of fixed maturities were mortgage-backed securities. Such securities are comprised of Collateralized Mortgage Obligations (CMOs) and pass through securities. The Company routinely assesses its vulnerability to both prepayment risk and fluctuations in interest rates on these securities. Based on reviews of the Company's portfolio of mortgage-backed securities, the impact of upward fluctuations in interest rates is currently a greater concern than that of prepayment risk due to record low mortgage rates during the last year. At June 30, 2004, the Company's total portfolio of fixed maturities had gross unrealized gains of \$45,075,523 and gross unrealized losses of \$21,045,200. Securities are priced by nationally recognized pricing services or by broker/dealer securities firms. No securities were priced by the Company.

During the first six months of 2004, the Company sold approximately \$11.9 million in fixed maturities available for sale. These sales resulted in gross realized gains of \$52,129 and gross realized losses of \$355,450. During the same period in 2003, the Company sold approximately \$24.7 million in fixed maturities available for sale. These sales resulted in gross realized gains of \$570,577 and gross realized losses of \$260,266.

The Company monitors its level of investments in high yield fixed maturities and equity investments held in issuers of high yield debt securities. Management believes the level of such investments is not significant to the Company's financial condition. At June 30, 2004, the Company had unrealized gains of approximately \$4.9 million in such investments. During the first six months of 2004, the Company recognized a net loss of \$151,375 on disposals of high yield debt securities. At June 30, 2003, the Company had unrealized gains of approximately \$1.1 million in such investments.

During the first six months of 2004, the Company did not write down any securities as declines in value were deemed to be temporary.

The Company's other investments consist primarily of assets leased under operating leases, investments in partnerships and joint ventures in addition to consumer loans and commercial leases originated by the finance subsidiary. These loans and leases are collateralized by automobiles, equipment and other property. At June 30, 2004, the delinquency ratio on the loan portfolio was 1.10% or \$1.2 million, down from 1.52% or \$1.5 million at December 31, 2003. The delinquency ratio on the lease portfolio at June 30, 2004 was 2.92% or \$4.5 million, down from 2.29%

or \$3.1 million at December 31, 2003. Credit losses of approximately \$269,800 were

Table of Contents

incurred in the first six months of 2004 including an increase of approximately \$57,000 in general reserves attributable to growth of the consumer loan portfolio. Leases charged off in the first six months of 2004 were approximately \$1,095,300. At June 30, 2004, the Company maintained an allowance for loan losses of \$1,205,869 or approximately 1.1% of the outstanding loan balance. In addition, at June 30, 2004, the Company maintained an allowance for lease losses of \$5,083,120 or approximately 3.3% of the outstanding lease balance.

During the third quarter of 2002, the Company's finance subsidiary, Alfa Financial Corporation, invested \$13.5 million in MidCountry Financial, a financial services holding company with two wholly-owned subsidiaries, Heights Finance Corp and Bayside Bank. Heights Finance Corp. was acquired by MidCountry Financial on August 30, 2002 and is a consumer finance company doing business in five Midwestern states. Bayside Bank is a federally chartered savings bank headquartered in Minnetonka, Minnesota. Bayside Bank was acquired by MidCountry Financial at the end of 2003. Alfa Financial's investment in MidCountry Financial gave it a 42 percent ownership in the newly formed entity. As a result of this significant ownership percentage, Alfa Financial accounts for earnings from MidCountry Financial using the equity method of accounting. Pre-tax operating income of approximately \$434,000 positively impacted the first six months of 2004.

INCOME TAXES

The effective tax rate in the first six months of 2004 was 27.2% compared to 26.4% for the full year 2003 and 27.4% for the first six months of 2003. The decrease in the effective tax rate in the first six months of 2004 is due to increases in tax credits resulting from investments in partnerships established to construct and manage affordable housing. The increase over the 2003 full-year effective rate is due to increases in income before provision for income taxes adjusted by the relative mix of taxable versus tax-exempt income. Based on information available at June 30, 2004, the Company currently anticipates the effective tax rate recorded in the financial statements for the six-month period ending June 30, 2004 to approximate the effective tax rate for all of 2004.

IMPACT OF INFLATION

Inflation increases consumers' needs for both life and property and casualty insurance coverage. Inflation increases claims incurred by property and casualty insurers as property repairs, replacements and medical expenses increase. Such cost increases reduce profit margins to the extent that rate increases are not maintained on an adequate and timely basis. Since inflation has remained relatively low in recent years, financial results have not been significantly impacted by inflation.

LIQUIDITY AND CAPITAL RESOURCES

The Company receives funds from its subsidiaries consisting of dividends, payments for funding federal income taxes, and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used for paying dividends to stockholders, corporate interest and expenses, federal income taxes, and for funding additional investments in its subsidiaries' operations.

Table of Contents

The Company's subsidiaries require cash in order to fund policy acquisition costs, claims, other policy benefits, interest expense, general operating expenses, and dividends to the Company. The major sources of the Company's liquidity are operations and cash provided by maturing or liquidated investments. A significant portion of the Company's investment portfolio consists of readily marketable securities which can be sold for cash. Based on a review of the Company's matching of asset and liability maturities and on the interest sensitivity of the majority of policies in force, management believes the ultimate exposure to loss from interest rate fluctuations is not significant.

Net cash provided by operating activities for the first six months of 2004 and 2003 approximated \$59.5 million and \$68.4 million, respectively. Such net positive cash flows provide the foundation of the Company's assets/liability management program and are the primary drivers of the Company's liquidity. As previously discussed, the Company also maintains a diversified portfolio of fixed maturity and equity securities which provide a secondary source of liquidity should net cash flows from operating activities prove inadequate to fund current operating needs. Management believes that such an eventuality is unlikely given the Company's product mix (primarily short-duration personal lines property and casualty products), its ability to adjust premium rates (subject to regulatory oversight) to reflect emerging loss and expense trends and its catastrophe reinsurance program, amongst other factors.

The Company has a limited number of contractual obligations in the form of operating leases and debt obligations. These leases have primarily been originated by its commercial leasing and real estate sales subsidiaries. Operating leases supporting the corporate headquarters are the responsibility of Alfa Mutual Insurance Company (Mutual), an affiliate. In turn, the Company reimburses Mutual monthly for a portion of these and other expenses based on a management and operating agreement. There are currently no plans to change the structure of this agreement. Included in the Company's contractual obligations is the repayment of a \$70 million debt obligation. This note, issued in the second quarter of 2002, is payable at the end of fifteen years. While the note carries a variable interest rate, the Company has entered into an interest rate swap contract to hedge interest rate variability and fix the interest rate for the first five years of the debt obligation at 4.945%.

The Company's contractual obligations at June 30, 2004 are summarized below:

| | Payments Due by Period | | | | |
|--------------------------------------|------------------------|----------------------|-------------------|-----------|----------------------|
| | | Less | | | |
| | | than 1 | 1 - 3 | 4 - 5 | After 5 |
| | Total | year | years | years | years |
| Operating Lease Obligations | \$ 262,829 | \$ 145,740 | \$ 117,089 | \$ | \$ |
| Capital Lease Obligations | | | | | |
| Unconditional Purchase Obligations | | | | | |
| Notes Payable to Affiliates | 36,981,317 | 36,981,317 | | | |
| Long-Term Debt Obligations | 70,000,000 | | | | 70,000,000 |
| Other Long-Term Obligations | | | | | |
| Total Contractual Obligations | \$ 107,244,146 | \$ 37,127,057 | \$ 117,089 | \$ | \$ 70,000,000 |

Table of Contents

The Company maintains a variety of funding agreements in the form of lines of credit with affiliated entities. The chart below depicts, at June 30, 2004, the cash outlay by the Company representing the potential full repayment of lines of credit it has outstanding with others. Also included with the amounts shown as lines of credit are the potential amounts the Company would have to supply to other affiliated entities if they made full use of their existing lines of credit during 2004 with the Company's finance subsidiary, Alfa Financial Corporation. Other commercial commitments of the Company shown below include commercial paper outstanding, scheduled fundings of partnerships, funding of a policy administration system project of the life subsidiary and loans sold to members of the Alfa Mutual Group through which recourse against the finance subsidiary is available if repayment by the customer fails to occur.

| | Amount of Commitment Expiration Per Period | | | | |
|--------------------------------|--|----------------|---------------|---------------|------------|
| | Total | Less | | | |
| | Amounts | than 1 | 1 - 3 | 4 - 5 | After 5 |
| | Committed | year | years | years | years |
| Lines of Credit | \$ 31,565,000 | \$ 3,400,000 | \$ 5,015,000 | \$ 23,150,000 | \$ |
| Standby Letters of Credit | | | | | |
| Guarantees | 5,836,016 | 200,000 | | 5,636,016 | |
| Standby Repurchase Obligations | | | | | |
| Other Commercial Commitments | 261,086,345 | 245,264,496 | 15,156,166 | 466,006 | 199,677 |
| Total Commercial Commitments | \$ 298,487,361 | \$ 248,864,496 | \$ 20,171,166 | \$ 29,252,022 | \$ 199,677 |

Assessment of credit risk is a critical factor in the Company's consumer loan and commercial leasing subsidiary. All credit decisions are made by personnel trained to limit loss exposure from unfavorable risks. In attempting to manage risk, the Company regularly reviews delinquent accounts and adjusts reserves for potential loan losses and potential lease losses. To the extent these reserves are inadequate at the time an account is written off, income would be negatively impacted. In addition, the Company monitors interest rates relative to the portfolio duration. Rising interest rates on commercial paper issued, the primary source of funding portfolio growth, could reduce the interest rate spread if the Company failed to adequately adjust interest rates charged to customers.

Total borrowings increased approximately \$28.9 million in the first six months of 2004 to \$300.5 million. The majority of the short-term debt is commercial paper issued by the Company. At June 30, 2004, the Company had approximately \$193.5 million in commercial paper at rates ranging from 1.17% to 1.35% with maturities ranging from July 2, 2004 to August 11, 2004. The Company intends to continue to use the commercial paper program as a major source to fund the consumer loan portfolio, commercial lease portfolio and other corporate short-term needs. In addition, the Company had \$37.0 million in short-term debt outstanding to affiliates at June 30, 2004 with interest equal to commercial paper rates payable monthly. Also included in total borrowings is a variable rate note issued by the Company during the second quarter of 2002 in the amount of \$70 million. This note is payable in its entirety at the end of fifteen years with interest payments due monthly. The Company is using the proceeds of this note to partially fund the consumer loan and commercial lease portfolios of its finance subsidiary. The Company has entered into an interest rate swap contract in order to achieve its objective of economically hedging 100 percent of its variable-rate long-term interest payments over the first five years of the note. Under the interest rate swap, the Company receives variable interest payments and makes fixed interest rate payments, thereby fixing the rate on such debt at 4.945%. The interest rate swap involves a LIBOR for LIBOR exchange and meets the criteria for short-cut accounting.

Table of Contents

The commercial paper and variable/fixed rate promissory note are guaranteed by two affiliates, Alfa Mutual Insurance Company and Alfa Mutual Fire Insurance Company up to an aggregate limit of \$300 million. Backup lines of credit are also in place up to \$300 million. The backup lines agreements contain usual and customary covenants requiring the Company to meet certain operating levels. The Company has maintained full compliance with all such covenants. The Company has earned A-1+ and P-1 commercial paper ratings from Standard & Poor's and Moody's Investors Service, respectively.

On October 25, 1993, the Company established a Stock Option Plan, pursuant to which a maximum aggregate of 4,000,000 shares of common stock were reserved for grant to key personnel. On April 26, 2001, the plan was amended to increase the maximum aggregate number of shares available for grant to 6,400,000 shares. Under the plan, options ratably become exercisable annually over three years and may not be exercised after ten years from the date of the award. During February 2004, the Company issued 780,400 options.

In October 1989, the Company's Board of Directors approved a stock repurchase program authorizing the repurchase of up to 4,000,000 shares of its outstanding common stock in the open market or in negotiated transactions in such quantities and at such times and prices as management may decide. The Board increased the number of shares authorized for repurchase by 4,000,000 in both March 1999 and September 2001, bringing the total number of shares authorized for repurchase to 12,000,000. During the first six months of 2004, the Company repurchased 562,900 shares at a cost of \$7,571,656. At June 30, 2004, the total repurchased was 7,710,680 shares at a cost of \$57,841,380. Stock repurchase activity for the three months ended June 30, 2004 is summarized below:

| | Shares | Average Price Per Share |
|--|------------|----------------------------|
| Total Shares Authorized to Be Repurchased | 12,000,000 | |
| Less: Total Shares Repurchased at March 31, 2004 | 7,477,480 | |
| Shares Repurchased | | |
| April 2004 | 69,800 | \$ 13.54 |
| May 2004 | 149,800 | \$ 13.42 |
| June 2004 | 13,600 | \$ 13.56 |
| Total Shares Repurchased in Three Months Ended June 30, 2004 | 233,200 | \$ 13.46 |
| Total Shares Repurchased under Stock Repurchase Program | 7,710,680 | |
| Total Shares Available for Repurchase | 4,289,320 | |

The Company has reissued 2,362,798 treasury shares as a result of option exercises. In May 2002, the Company began selling treasury shares as a means of meeting provisions of stockholder participation in the Company's dividend reinvestment plan. At June 30, 2004, the total sold was 1,595,609 shares at a cost of \$9,576,005.

Table of Contents

All share information presented in this section has been adjusted to reflect the impact of the two-for-one stock split effected in the form of a 100% stock dividend which was paid on June 17, 2002.

Due to the sensitivity of the products offered by the life subsidiary to interest rates fluctuations, the Company must assess the risk of surrenders exceeding expectations factored into its pricing program. Internal actuaries are used to determine the need for modifying the Company's policies on surrender charges and assessing the Company's competitiveness with regard to rates offered.

Cash surrenders paid to policyholders on a statutory basis totaled \$9.0 million and \$8.0 million in the first six months of 2004 and 2003, respectively. This level of surrenders is within the Company's pricing expectations. Historical persistency rates indicate a normal pattern of surrender activity. The structure of the surrender charges is such that persistency is encouraged. The majority of the policies in force have surrender charges which grade downward over a 12 to 15 year period. In addition, the majority of the in-force business is interest sensitive type policies which generally have lower rates of surrender. At June 30, 2004, the total amount of cash that would be required to fund all amounts subject to surrender was approximately \$580.3 million.

The Company's business is concentrated geographically in Alabama, Georgia and Mississippi. Accordingly, unusually severe storms or other disasters in these contiguous states might have a more significant effect on the Company than on a more geographically diversified insurance company. Unusually severe storms, other natural disasters and other events could have an adverse impact on the Company's financial condition and operating results. However, the Company's current catastrophe protection program, which began November 1, 1996, reduced the earnings volatility caused by such catastrophe exposures.

The Company's management uses estimates in determining loss reserves for inclusion in its financial statements. Periodic reviews are conducted by the Company's internal actuaries to determine a range of reasonable loss reserves. In addition, the Company's current catastrophe protection program, which began November 1, 1996, was established to address the economics of catastrophe finance. This plan limits the Company's exposure to catastrophes which might otherwise deplete the Company's surplus through the combination of shared catastrophe exposure within the Alfa Group and the purchase of reinsurance coverage from external reinsurers.

Reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; therefore, allowances are established if amounts are determined to be uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurance to minimize exposure to significant losses from reinsurer insolvencies. At June 30, 2004, the Company does not believe there to be a significant concentration of credit risk related to its reinsurance program.

Lawsuits brought by policyholders or third-party claimants can create volatility in the Company's earnings. The Company maintains in-house legal staff and, as needed, secures the services of external legal firms to

Table of Contents

present and protect its position. Certain legal proceedings are in process at June 30, 2004. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims, and miscellaneous other causes of action. These lawsuits involve claims for mental anguish and punitive damages. Costs for these and similar proceedings, including accruals for outstanding cases, are included in the financial statements of the Company. Management periodically reviews reserves established to cover potential costs of litigation including legal fees and potential damage assessments and adjusts them based on their best estimates. It should be noted that in Mississippi and Alabama, where the Company has substantial business, the likelihood of a judgment in any given suit, including a large mental anguish and/or punitive damage award by a jury, bearing little or no relation to actual damages, continues to exist, creating the potential for unpredictable material adverse financial results.

Increased public interest in the availability and affordability of insurance has prompted legislative, regulatory and judicial activity in several states. This includes efforts to contain insurance prices, restrict underwriting practices and risk classifications, mandate rate reductions and refunds, eliminate or reduce exemptions from antitrust laws and generally expand regulation. In 1999, the Alabama legislature passed a tort reform package that should help to curb some of the excessive litigation experienced in recent years. In addition, a mandatory insurance bill was passed to require motorists to obtain insurance coverage beginning in June 2000. While this requirement will affect both the revenues and losses incurred by the Company in the future, the full extent or impact is not possible to predict and the Company believes any impact on future results will not be significant.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

The Company's Summary of Significant Accounting Policies is presented in the notes to its audited consolidated financial statements for the fiscal year ended December 31, 2003. As the Company operates in the property and casualty and life insurance industries, its accounting policies are well defined with industry-specific accounting literature governing the recognition of insurance-related revenues and expenses.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company's management to make significant estimates and assumptions based on information available at the time the financial statements are prepared. In addition, management must ascertain the appropriateness and timing of any changes in these estimates and assumptions. Certain accounting estimates are particularly sensitive because of their significance to the Company's financial statements and because of the possibility that subsequent events and available information may differ markedly from management's judgments at the time financial statements are prepared. For the Company, the areas most subject to significant management judgments include reserves for property and casualty losses and loss adjustment expenses, reserves for future policy benefits, deferred policy acquisition costs, valuation of investments, and reserves for pending litigation. The application of these critical accounting estimates impacts the values at which 74% of the Company's assets and 59% of the Company's liabilities are reported and therefore have a direct effect on net earnings and stockholders' equity.

Management routinely discusses changes in the Company's critical accounting policies and estimates with the Audit Committee of the Company's Board of Directors. The Company's Audit Committee has also reviewed the disclosures contained herein.

Table of Contents*RESERVES FOR PROPERTY CASUALTY LOSSES AND LOSS ADJUSTMENT EXPENSES*

The estimated liabilities for losses and loss adjustment expenses include the accumulation of estimates of losses for claims reported prior to the balance sheet dates, estimates of losses for claims incurred but not reported and the development of case reserves to ultimate values, and estimates of expenses for investigating, adjusting and settling all incurred claims. Amounts reported are estimates of the ultimate costs of settlement, net of estimated salvage and subrogation. The estimates are necessarily subject to the outcome of future events, such as changes in medical and repair costs as well as economic, political and social conditions that impact the settlement of claims. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement amount can be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims. Due to the Company's current mix of exposures, the majority of claims are settled within twelve months of the date of loss. The amount of loss reserves for reported claims is based primarily upon a case-by-case evaluation of the risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions related to the type of loss. The amounts of loss reserves for unreported claims and loss adjustment expenses are determined using historical information by line of business as adjusted to current conditions. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Organized by accident year and evaluation dates, historical data on paid losses, loss adjustment expenses, case reserves, earned premium, catastrophe losses and carried reserves is provided to the Company's actuaries who apply standard actuarial techniques to estimate a range of reasonable reserves. The carried reserve is then compared to these estimates to determine whether it is reasonable and whether any adjustments need to be recorded. The Company's appointed actuary conducts his own analysis and renders an opinion as to the adequacy of the reserves. Reserve estimates are closely monitored and are rolled forward quarterly using the most recent information on reported claims. Each quarter, after the rolled forward analysis has been completed, a meeting is held to discuss the actuarial data. Management evaluates reserve level estimates across various segments and adjustments are made as deemed necessary. It is expected that such estimates will be more or less than the amounts ultimately paid when the claims are settled. Changes in these estimates are reflected in current operating results. An increase in the ending reserve for incurred but not reported losses of 1% would have negatively impacted income before income taxes by \$426,809 at June 30, 2004. Similarly, increases of 1% in the reserves for unpaid losses and loss adjustment expenses would have reduced pretax earnings by \$740,470 and \$276,897, respectively. Due to the Company's geographically-concentrated operations, it is possible that changes in assumptions based on regional data could cause fluctuations in reported results. However, the Company's exposure to large adjustments in these reserves created by these assumption changes is partially limited by its participation in the Alfa Insurance Group's catastrophe protection program. Historically, the Company's reserves, in the aggregate, have been adequate when compared to actual results. Given the inherent variability in the estimates, management believes the aggregate reserves are within a reasonable and acceptable range of adequacy.

Table of Contents

RESERVES FOR POLICYHOLDER BENEFITS

Benefit reserves for traditional life products are determined according to the provisions of Statement of Financial Accounting Standard (SFAS) No. 60, Accounting and Reporting by Insurance Enterprises. The methodology used requires that the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums (that portion of the gross premium required to provide for all future benefits and expenses) be determined. Such determination uses assumptions, including provision for adverse deviation, for expected investment yields, mortality, terminations and maintenance expenses applicable at the time the insurance contracts are issued. These assumptions determine the level and the sufficiency of reserves. The Company annually tests the validity of these assumptions.

Benefit reserves for universal life products are determined according to the provisions of SFAS No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments. This standard directs that, for policies with an explicit account balance, the benefit reserve is the account balance without reduction for any applicable surrender charge. Benefit reserves for the Company's annuity products, like those for universal life products, are determined using the requirements of SFAS No. 97.

In accordance with the provisions of SFAS No. 60 and the AICPA Audit and Accounting Guide, credit insurance reserves are held as unearned premium reserves calculated using the rule of 78 method. Reserves for supplementary contracts with life contingencies are determined using the 1971 Individual Annuity Mortality Table and an interest rate of 7.5%. Likewise, reserves for accidental death benefits are determined predominately by using the 1959 Accidental Death Benefit Mortality Table and an interest rate of 3%. Reserves for disability benefits, both active and disabled lives, are calculated primarily from the 1952 Disability Study and a rate of 2.5%. A small portion of the Company's disabled life reserves are calculated based on the 1970 Intercompany Group Disability Study and a rate of 3%.

Reserves for all other benefits are computed in accordance with presently accepted actuarial standards. Management believes that reserve amounts reflected in the Company's balance sheet related to life products:

are consistently applied and fairly stated in accordance with sound actuarial principles;

are based on actuarial assumptions which are in accordance with contract provisions;

make a good and sufficient provision for all unmatured obligations of the Company guaranteed under the terms of its contracts;

are computed on the basis of assumptions consistent with those used in computing the corresponding items of the preceding year end; and

include provision for all actuarial reserves and related items which ought to be established.

VALUATION OF INVESTMENTS

Edgar Filing: ALFA CORP - Form 10-Q

Unrealized investment gains or losses on investments carried at fair value, net of applicable income taxes, are reflected directly in stockholders equity as a component of accumulated other comprehensive income (loss) and, accordingly, have no effect of net income. Fair values for fixed maturities are based on quoted market prices. The cost of investment securities sold is determined by the specific identification method. The Company monitors its investment portfolio and conducts quarterly reviews of investments that have experienced a decline in fair value below cost to evaluate whether the decline is other than temporary. Such evaluations involve judgment and consider the magnitude and reasons for a decline and the prospects for the fair value to recover in the near term. Declines in value created by market conditions or industry related events, and for which the

Table of Contents

Company has the intent to hold the investment for a period of time believed to be sufficient to allow a market recovery or to maturity, are considered to be temporary. Future adverse investment market conditions, or poor operating results of underlying investments, could result in an impairment charge in the future. Where a decline in fair value of an investment below its cost is deemed to be other than temporary, a charge is reflected in income for the difference between the cost or amortized cost and the estimated net realizable value. No writedowns on equity securities or fixed maturities were recorded in the first six months of 2004.

POLICY ACQUISITION COSTS

Policy acquisition costs, such as commissions, premium taxes and certain other underwriting and marketing expenses that vary with and are directly related to the production of business have been deferred. Traditional life insurance acquisitions costs are being amortized over the premium payment period of the related policies using assumptions consistent with those used in computing policy benefit reserves. Acquisition costs for universal life type policies are being amortized over the lives of the policies in relation to the present value of estimated gross profits which are determined based upon surrender charges and investment, mortality and expense margins. Investment income is considered, if necessary, in the determination of the recoverability of deferred policy acquisition costs. Acquisition costs for property and casualty insurance are amortized over the period in which the related premiums are earned. Future changes in estimates, such as the relative time certain employees spend in initial policy bookings, may require adjustments to the amounts deferred. Changes in underwriting and policy issuance processes may also give rise to changes in these deferred costs.

RESERVES FOR LITIGATION

The Company is subject to proceedings, lawsuits and claims in the normal course of business related to its insurance and noninsurance products. At the time a case becomes known, management evaluates the merits of the claim and determines the need for establishing estimated reserves for potential settlements or judgments as well as reserves for potential costs of defending the Company against the claim. These reserves may be adjusted as the matter develops. On a quarterly basis, management assesses all pending cases as a basis for evaluating reserve levels. At that point, any necessary adjustments are made to applicable reserves as determined by management and are included in current operating results. Reserves may be adjusted based upon outside counsels' advice regarding the law and facts of the case, any revisions in the law applicable to the case, the results of depositions and/or other forms of discovery, whether or not an outside carrier provides a defense and/or indemnification, whether a verdict is rendered for or against the Company, whether management believes an appeal will be successful, or other factors that may affect the anticipated outcome of the case. Management believes adequate reserves have been established in known cases. However, due to the uncertainty of future events, there can be no assurance that actual outcomes will not differ from the assessments made by management.

FINANCIAL ACCOUNTING DEVELOPMENTS

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of FASB Statement No. 123. While the Company continues to use the intrinsic value method to account for its stock options, notes contained in this filing for three-month period ended June 30, 2004 have been enhanced to comply with the requirements set forth by this statement.

Table of Contents

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities. This interpretation addresses consolidation and disclosure issues associated with variable interest entities. The effective date for the interpretation has been delayed to December 31, 2003 on those variable interest entities in existence prior to February 1, 2003. The Company has evaluated the provisions of this interpretation and its requirements had no significant impact on the Company's financial position or income.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. The changes in this statement improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. These changes will result in more consistent reporting of contracts as either derivatives or hybrid instruments. This statement is effective for contracts entered into or modified after June 30, 2004 and for hedging relationships designated after June 30, 2004. At this time, the Company does not anticipate this standard having a significant impact on the Company's financial position or income.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and is effective for financial instruments entered into or modified after May 31, 2003. The Company did not experience a significant impact on the Company's financial position or income from this statement.

In July 2003, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts for Separate Accounts. This SOP became effective for fiscal years beginning after December 15, 2003. The new rule changes accounting for separate accounts and sales inducements and changes the liability model by expanding the definition of account balance and addressing annuitization guarantees and minimum guaranteed death benefits. The Company has implemented this SOP effective January 1, 2004 and it did not have a significant impact on its financial position or income.

INFORMATION ABOUT FORWARD-LOOKING STATEMENTS

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning the Company or its business, whether expressed or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on assumptions and opinions concerning a variety of known and unknown risks, including but not necessarily limited to changes in market conditions, natural disasters and other catastrophic events, increased competition, changes in availability and cost of reinsurance, changes in governmental regulations, technological changes, political and legal contingencies and general economic conditions, as well as other risks and uncertainties more completely described in the Company's filings with the Securities and Exchange Commission. If any of these assumptions or opinions prove incorrect, any forward-looking statements made on the basis of such assumptions or opinions may also prove materially incorrect in one or more respects and may cause actual future results to differ materially from those contemplated, projected, estimated or budgeted in such forward-looking statements.

Table of Contents

Item 3.

MARKET RISK DISCLOSURES

The Company's objectives in managing its investment portfolio are to maximize investment income and investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including underwriting results, overall tax position, regulatory requirements, and fluctuations in interest rates. Investment decisions are made by management and approved by the Board of Directors. Market risk represents the potential for loss due to adverse changes in the fair value of securities. The market risk related to the Company's fixed maturity portfolio are primarily interest rate risk and prepayment risk. The market risk related to the Company's equity portfolio is equity price risk. For further information, reference is made to Management's Discussion and Analysis of Results of Operations in Alfa Corporation's Annual Report on Form 10-K for the year ended December 31, 2003.

Table of Contents

Item 4.

CONTROLS AND PROCEDURES

The Company has evaluated the effectiveness of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. The evaluation was performed under the supervision and with the participation of the Company's Disclosure Committee and Management, including the Chief Executive Officer and the Chief Financial Officer, within 90 days prior to the date of the filing of this quarterly report. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion.

Subsequent to the date of their evaluation, there were no significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

Table of Contents

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Certain legal proceedings are in process at June 30, 2004. Costs for these and similar legal proceedings, including accruals for outstanding cases, totaled \$161,000 in the first six months of 2004, \$1.1 million in 2003, and \$5.3 million in 2002. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims, and miscellaneous other causes of action. These lawsuits involve claims for unspecified amounts of compensatory damages, mental anguish damages, and punitive damages.

Approximately 20 legal proceedings against Alfa Life Insurance Corporation (Life) were in process at June 30, 2004. Of the 20 proceedings, seven were filed in 2004, eight were filed in 2003, one was filed in 2002, three were filed in 1999, and one was filed in 1996. One of the 20 pending cases was filed as a purported class action, but no class has been certified. In a case tried in January 2001, in Barbour County, Alabama, the jury returned a verdict for the plaintiff against Life for \$500,000 in compensatory damages and \$5,000,000 in punitive damages. After Life filed post-trial motions, the trial court reduced the punitive damage award to \$1,500,000. On appeal, the Alabama Supreme Court further reduced the total judgment to \$400,000. Life has filed an Application for Rehearing with the Court seeking a further reduction of the award.

In addition, one purported class action lawsuit is pending against both Alfa Builders, Inc. and Alfa Mutual Fire Insurance Company. Additionally, three purported class action lawsuits are pending against the property and casualty companies involving a number of issues and allegations which could affect the Company because of a pooling agreement between the companies. No class has been certified in any of these four purported class action cases. In the event a class is certified in any of these purported class actions, reserves may need to be adjusted.

Management believes adequate accruals have been established in these known cases. However, it should be noted that in Mississippi and Alabama, where the Company has substantial business, the likelihood of a judgment in any given suit, including a large mental anguish and/or punitive damage award by a jury, bearing little or no relation to actual damages, continues to exist, creating the potential for unpredictable material adverse financial results.

Based upon information presently available, unreserved contingent liabilities arising from any other threatened litigation are not presently considered by management to be material.

Table of Contents

Item 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

Item 3. DEFAULTS UPON SENIOR SECURITIES

None

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

Item 5. OTHER INFORMATION

None

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

- 11 - Statement of Computation of Per Share Earnings
- 15 - Letter Regarding Unaudited Interim Financial Information
- 31.1 - Certification of Alfa Corporation's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 - Certification of Alfa Corporation's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 - Certification of Alfa Corporation's Chief 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 Alfa Corporation's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

Edgar Filing: ALFA CORP - Form 10-Q

| <u>Date of Report</u> | <u>Date Filed</u> | <u>Description</u> |
|-----------------------|-------------------|--|
| April 21, 2004 | April 21, 2004 | Regulation FD disclosure of Alfa Corporation's press release regarding its results of operations for the three-month period ending March 31, 2004. |

Items other than those listed above are omitted because they are not required or are not applicable.

Table of Contents

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.

ALFA CORPORATION

Date 8/4/04

By: /S/ Jerry A. Newby

Jerry A. Newby
President
(Chief Executive Officer)

Date 8/4/04

By: /S/ Stephen G. Rutledge

Stephen G. Rutledge
Senior Vice President
(Chief Financial Officer and Chief Investment Officer)