

## CONSOLIDATED BALANCE SHEETS

in thousands, except per share data	December 31	2009	2008
Assets			
Investments:			
Fixed income:			
Available-for-sale, at fair value (amortized cost – \$1,240,203 in 2009 and \$1,236,676 in 2008)		\$1,273,518	\$1,224,215
Held-to-maturity, at amortized cost (fair value – \$209,019 in 2009 and \$41,421 in 2008)		210,888	39,821
Trading, at fair value (amortized cost – \$994 in 2009 and \$10,282 in 2008)		941	10,020
Equity securities available-for-sale, at fair value (cost – \$177,681 in 2009 and \$251,283 in 2008)		262,693	286,790
Short-term investments, at cost which approximates fair value		104,462	97,982
Total investments		1,852,502	1,658,828
Cash		–	–
Accrued investment income		16,845	17,226
Premiums and reinsurance balances receivable, net of allowances for uncollectible amounts of \$14,637 in 2009 and \$14,740 in 2008		83,961	92,149
Ceded unearned premiums		65,379	65,977
Reinsurance balances recoverable on unpaid losses and settlement expenses, net of allowances for uncollectible amounts of \$16,841 in 2009 and \$15,803 in 2008		336,392	350,284
Deferred policy acquisition costs, net		75,880	78,520
Property and equipment, at cost, net of accumulated depreciation of \$35,943 in 2009 and \$43,218 in 2008		19,110	21,565
Income taxes – deferred		–	24,141
Investment in unconsolidated investee		44,286	38,697
Goodwill		26,214	26,214
Other assets		18,084	45,800
Total assets		\$2,538,653	\$2,419,401
Liabilities and Shareholders' Equity			
Liabilities:			
Unpaid losses and settlement expenses		\$1,146,460	\$1,159,311
Unearned premiums		312,527	335,170
Reinsurance balances payable		22,431	30,224
Income taxes – deferred		24,299	–
Bonds payable, long-term debt		100,000	100,000
Accrued expenses		41,835	32,894
Other liabilities		58,851	53,648
Total liabilities		\$1,706,403	\$1,711,247
Shareholders' equity:			
Common stock (\$1 par value, authorized 50,000,000 shares, issued 32,179,091 shares in 2009 and 32,106,085 shares in 2008)		32,179	32,106
Paid-in capital		207,386	196,989
Accumulated other comprehensive earnings, net of tax		77,411	15,130
Retained earnings		877,791	807,195
Deferred compensation		7,989	8,312
Treasury stock, at cost (10,914,368 shares in 2009 and 10,631,656 shares in 2008)		(370,506)	(351,578)
Total shareholders' equity		\$ 832,250	\$ 708,154
Total liabilities and shareholders' equity		\$2,538,653	\$2,419,401

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

## CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

in thousands, except per share data	Years Ended December 31	2009 <sup>(1)</sup>	2008 <sup>(1)</sup>	2007 <sup>(1)</sup>
Net premiums earned		\$491,961	\$ 528,764	\$544,478
Net investment income		67,346	78,986	78,901
Net realized investment gains (losses)		32,538	29,427	28,966
Other-than-temporary-impairment losses on investments <sup>(1)</sup>		(45,293)	(76,165)	–
Consolidated revenue		546,552	561,012	652,345
Losses and settlement expenses		203,388	247,174	190,868
Policy acquisition costs		162,020	163,320	155,610
Insurance operating expenses		39,768	35,207	42,235
Interest expense on debt		6,050	6,704	6,997
General corporate expenses		7,941	6,853	9,474
Total expenses		419,167	459,258	405,184
Equity in earnings of unconsolidated investee		5,052	4,844	7,315
Earnings before income taxes		132,437	106,598	254,476
Income tax expense (benefit):				
Current		23,687	33,721	75,551
Deferred		14,905	(5,799)	3,058
Income tax expense		38,592	27,922	78,609
Net earnings		\$ 93,845	\$ 78,676	\$175,867
Other comprehensive earnings (loss), net of tax				
Unrealized gains (losses) on securities:				
Unrealized holding gains (losses) arising during the period		\$ 53,995	\$(111,152)	\$ 9,339
Less: Reclassification adjustment for losses (gains) included in net earnings		8,286	30,581	(18,783)
Other comprehensive earnings (loss) (OCI)		62,281	(80,571)	(9,444)
Comprehensive earnings (loss)		\$156,126	\$ (1,895)	\$166,423
Earnings per share:				
Basic – Net earnings per share		\$4.35	\$ 3.65	\$7.46
Comprehensive earnings (loss) per share		\$7.24	\$(0.09)	\$7.06
Earnings per share:				
Diluted – Net earnings per share		\$4.32	\$ 3.60	\$7.30
Comprehensive earnings (loss) per share		\$7.18	\$(0.09)	\$6.91
Weighted average number of common shares outstanding:				
Basic		21,562	21,540	23,574
Diluted		21,731	21,848	24,085

<sup>(1)</sup> There were no OTTI losses recognized in OCI in the periods presented. 2008 and 2007 amounts were reclassified to conform to current period's presentation.

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)	Years ended December 31,	2009	2008	2007
Cash flows from operating activities				
Net earnings		\$ 93,845	\$ 78,676	\$ 175,867
Adjustments to reconcile net earnings to net cash provided by operating activities:				
Net realized investment losses (gains)		12,755	46,738	(28,966)
Depreciation		3,284	3,596	3,567
Other items, net		11,172	17,287	10,137
Change in:		381	1,070	332
Accrued investment income				
Premiums and reinsurance balances receivable (net of direct write-offs and commutations)		8,188	13,788	20,084
Reinsurance balances payable		(7,793)	(8,049)	(16,702)
Ceded unearned premium		598	5,044	26,575
Reinsurance balances recoverable on unpaid losses		13,892	66,966	108,421
Deferred policy acquisition costs		2,640	362	(5,065)
Accounts payable and accrued expenses		8,941	(6,409)	4,613
Unpaid losses and settlement expenses		(12,851)	(32,867)	(126,599)
Unearned premiums		(22,643)	(20,352)	(32,289)
Income taxes:				
Current		(3,412)	2,163	(12,250)
Deferred		14,905	(5,799)	3,058
Stock option excess tax benefit		(444)	(4,929)	(2,042)
Changes in investment in unconsolidated investees:				
Undistributed earnings		(5,052)	(4,844)	(7,315)
Dividends received		—	3,960	5,940
Net (cash used in) proceeds from trading portfolio activity		9,353	4,933	(343)
Net cash provided by operating activities		\$127,759	\$161,334	\$ 127,023

## CONTINUED

(in thousands)	Years ended December 31,	2009	2008	2007
Cash flows from Investing activities				
Purchase of:				
Fixed income, held-to-maturity		\$(231,456)	\$ —	\$ —
Fixed income, available-for-sale		(622,826)	(445,778)	(339,334)
Equity securities, available-for-sale		(123,861)	(123,415)	(101,332)
Short-term investments, net		—	(88,838)	—
Property and equipment		(11,565)	(6,002)	(4,456)
Proceeds from sale of:				
Fixed income, held-to-maturity		—	5,230	—
Fixed income, available-for-sale		230,604	143,074	99,360
Equity securities, available-for-sale		178,098	89,032	77,040
Short-term investments, net		23,715	—	18,926
Property and equipment		10,736	891	1,429
Proceeds from call or maturity of:				
Fixed income, held-to-maturity		60,412	28,870	32,722
Fixed income, available-for-sale		390,044	327,462	199,427
Note receivable		—	—	9,500
Net cash used in investing activities		\$ (96,099)	\$ (69,474)	\$ (6,718)
Cash flows from financing activities				
Proceeds from issuance of short-term debt		\$ —	\$ 54,017	\$ 80,619
Payment on short-term debt		—	(81,992)	(52,644)
Stock option excess tax benefit		444	4,929	2,042
Proceeds from stock option exercises		4,804	(150)	2,952
Treasury shares purchased		(19,251)	(47,904)	(133,268)
Treasury shares reissued		5,222	—	—
Cash dividends paid		(22,879)	(20,760)	(20,006)
Net cash used in financing activities		\$ (31,660)	\$(91,860)	\$(120,305)
Net decrease in cash		—	—	—
Cash at beginning of year		—	—	—
Cash at end of year		\$ —	\$ —	\$ —

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

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands, except per share data)	Common Shares	Total Shareholders' Equity	Common Stock	Paid-in Capital	Accumulated Other Comprehensive Earnings (Loss)	Retained Earnings	Deferred Compensation	Treasury Stock at Cost
Balance, January 1, 2007	24,272,978	\$756,520	\$31,690	\$187,632	\$105,145	\$594,147	\$7,744	\$(169,838)
Net earnings		\$175,867				175,867		
Other comprehensive loss, net of tax		(9,444)			(9,444)			
Treasury shares purchased	(2,297,694)	(133,268)						(133,268)
Deferred compensation under Rabbi trust plans		—					236	(236)
Stock option excess tax benefit		2,042		2,042				
Exercise of stock options	179,856	2,952	180	2,772				
Dividends declared (\$.87 per share)		(20,247)				(20,247)		
Balance, December 31, 2007	22,155,140	\$774,422	\$31,870	\$192,446	\$ 95,701	\$749,767	\$7,980	\$(303,342)
Net earnings		\$ 78,676				78,676		
Other comprehensive loss, net of tax		(80,571)			(80,571)			
Treasury shares purchased	(917,200)	(47,904)						(47,904)
Deferred compensation under Rabbi trust plans		—					332	(332)
Stock option excess tax benefit		4,929		4,929				
Exercise of stock options	236,489	(150)	236	(386)				
Dividends declared (\$.99 per share)		(21,248)				(21,248)		
Balance, December 31, 2008	21,474,429	\$708,154	\$32,106	\$196,989	\$ 15,130	\$807,195	\$8,312	\$(351,578)
Net earnings		\$ 93,845				93,845		
Other comprehensive earnings, net of tax		62,281			62,281			
Treasury shares purchased	(282,712)	(19,251)						(19,251)
Treasury shares reissued		5,222		5,222				
Deferred compensation under Rabbi trust plans		—					(323)	323
Stock option excess tax benefit		444		444				
Exercise of stock options	73,006	4,804	73	4,731				
Dividends declared (\$1.08 per share)		(23,249)				(23,249)		
<b>Balance, December 31, 2009</b>	<b>21,264,723</b>	<b>\$832,250</b>	<b>\$32,179</b>	<b>\$207,386</b>	<b>\$ 77,411</b>	<b>\$877,791</b>	<b>\$7,989</b>	<b>\$(370,506)</b>

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**A. DESCRIPTION OF BUSINESS:** We underwrite selected property and casualty insurance coverages. We conduct operations principally through three insurance companies. RLI Insurance Company (RLI Ins.), our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Ins., writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines insurance on an admitted basis in 48 states and the District of Columbia. RIC has authority to write fidelity and surety in North Carolina.

### B. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION:

The accompanying consolidated financial statements were prepared in conformity with GAAP (generally accepted accounting principles in the United States of America), which differ in some respects from those followed in reports to insurance regulatory authorities. The consolidated financial statements include the accounts of our holding company and our subsidiaries. All significant intercompany balances and transactions have been eliminated.

### C. ADOPTED ACCOUNTING STANDARDS

#### FASB Accounting Standards Codification

On July 1, 2009, the FASB Accounting Standards Codification (ASC) became the single official source of authoritative, nongovernmental GAAP, superseding existing FASB, AICPA, EITF and related literature. Prospectively, only one level of authoritative GAAP will exist, excluding the guidance issued by the Securities and Exchange Commission (SEC). All other literature will be non-authoritative. The codification does not change GAAP but instead reorganizes the U.S. GAAP pronouncements into accounting topics, and displays all topics using a consistent structure. As the codification does not change GAAP, it did not have a material impact on our financial statements. The codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. Previous references to applicable literature via our disclosures have been updated with references to the new codification section.

#### FASB ASC 323, "Investments — Debt and Equity Securities"

In November 2008, the FASB ratified the Emerging Issues Task Force ("EITF") consensus on Issue No. 08-6,

Equity Method Investment Accounting Considerations ("EITF 08-6") which addresses certain effects of ASC 805, Business Combinations ("Topic 805"), and Topic 810 on an entity's accounting for equity-method investments. The consensus indicates, among other things, that transaction costs for an investment should be included in the cost of the equity-method investment (and not expensed) and shares subsequently issued by the equity-method investee that reduce the investor's ownership percentage should be accounted for as if the investor had sold a proportionate share of its investment, with gains or losses recorded through earnings. We adopted EITF 08-6 on January 1, 2009, and the standard did not have an impact on our consolidated financial statements. Following the effective date of the ASC, EITF 08-06 was codified within ASC 323, Investments — Debt and Equity Securities.

FASB ASC 805, "Business Combinations" (previously SFAS No. 141(R), "Business Combinations")

On January 1, 2009, we adopted new GAAP guidelines in regard to business combinations. Assets and liabilities that arose from business combinations which occurred prior to the adoption of the most recent standard are not adjusted upon the adoption. Among other things, the recent standard broadens the scope of the previous guidance to include all transactions where an acquirer obtains control of one or more other businesses. It retains the guidance to recognize intangible assets separately from goodwill and requires, with limited exceptions, that all assets acquired and liabilities assumed, including certain contractual contingencies, be measured at their acquisition date fair values. Recent guidelines require most acquisition and restructuring costs to be expensed as incurred. Step acquisitions, once control is acquired, are to be recorded at the full amounts of the fair values of the identifiable assets, liabilities and the non-controlling interest in the acquiree. The guidelines also replace the reduction of asset values and recognition of negative goodwill with a requirement to recognize a gain in earnings. The adoption had no impact on our financial position or results of operations. We will apply the provisions as applicable.

FASB ASC 350, "Intangibles — Goodwill and Other" (previously FSP No. 142-3, "Determination of the Useful Life of Intangible Assets")

New GAAP guidance regarding the useful life of intangible assets became effective January 1, 2009. It amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under previous guidance.