

**THE MIDLAND COMPANY**

Annual Report 2006



**BEYOND STANDARD™**

performance

## THE MIDLAND COMPANY'S MISSION STATEMENT

To enhance shareholder value by being an indispensable partner to customers in chosen markets by providing value-adding specialty insurance products and services.

## COMPANY PROFILE

The Midland Company is a highly focused provider of specialty insurance products and services through its wholly owned subsidiary, American Modern Insurance Group. American Modern accounts for approximately 94 percent of Midland's consolidated revenue.

American Modern specializes in writing physical damage insurance and related coverages on manufactured housing, as well as coverage for site built homes, motorcycles, watercraft, snowmobiles, recreational vehicles, physical damage on long-haul trucks, extended service contracts, excess and surplus lines coverages, credit life and related products, as well as collateral protection and mortgage fire products sold to financial institutions and their customers.

Midland also owns a niche transportation business, M/G Transport Services, Inc., which operates a fleet of dry cargo barges for the movement of dry bulk commodities on the inland waterways.

Headquartered in Cincinnati, Ohio, the company has more than 1,200 associates, is licensed in all 50 states and enjoys an A+ (Superior) rating from A.M. Best. Midland's common stock is traded on the NASDAQ Global Select Market under the symbol MLAN.

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Please refer to  
"Forward Looking Statements"  
on page 22.

# FINANCIAL HIGHLIGHTS

THE MIDLAND COMPANY AND SUBSIDIARIES

For the Years Ended  
December 31,

(Amounts in thousands, except per share data)

**2006**                      **2005**

## Operating Performance

Revenues	\$ <b>789,268</b>	\$ 733,430
Net Income	\$ <b>70,695</b>	\$ 65,326

## Per Share Data

Basic Earnings Per Common Share	\$ <b>3.70</b>	\$ 3.46
Average Shares Outstanding for EPS — Basic	<b>19,081</b>	18,894
Diluted Earnings Per Common Share	\$ <b>3.60</b>	\$ 3.37
Average Shares Outstanding for EPS — Diluted	<b>19,658</b>	19,407
Cash Dividends	\$ <b>.245</b>	\$ .225
Market Value	\$ <b>41.95</b>	\$ 36.04
Book Value	\$ <b>29.90</b>	\$ 25.54

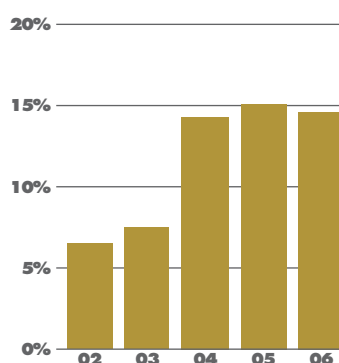
## Financial Position

Total Assets	\$ <b>1,569,528</b>	\$ 1,428,113
Shareholders' Equity	\$ <b>574,746</b>	\$ 484,377

## Combined Ratio

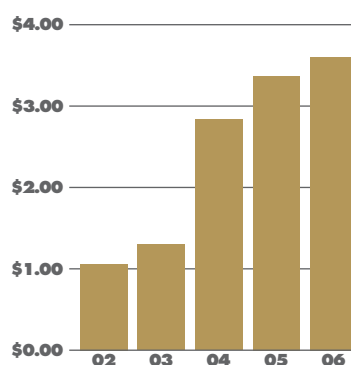
(American Modern's Property and Casualty Insurance Companies)	<b>93.8%</b>	93.8%
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**Return on Beginning Equity**



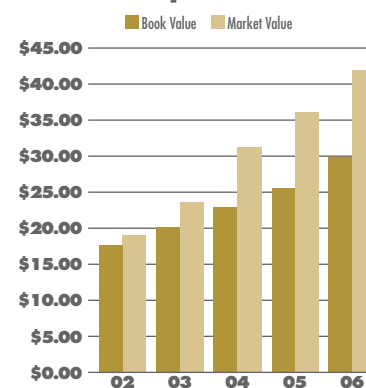
The Midland Company's Return on Beginning Equity was 14.6 percent, the third consecutive year of double-digit returns.

**Net Income per Share**



Net Income for 2006 was a record \$70.7 million, or \$3.60 per share, including 29 cents in net realized capital gains. Earnings per share have grown 19.0 percent over the last five years.

**Book Value, Market Value per Share**



Shareholders' equity reached records of \$574.7 million and \$29.90 per share, an increase of 17 percent from 2005. The company's book value per share and market value per share have grown at a compound annual rate of 13.1 percent and 20.7 percent over the last 10 years.

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## LETTER TO SHAREHOLDERS

### 2006 WAS A BEYOND STANDARD YEAR

Our mission is to deliver Beyond Standard products and services that will make us indispensable to our business partners and customers in chosen markets. That is a high standard of performance to expect from oneself. And, only those we serve are truly



**John W. Hayden,  
President and Chief  
Executive Officer**



**Joseph P. Hayden III,  
Chairman and Chief  
Operating Officer**

qualified to say if we have achieved it. But, if traditional standards of measure are any indication, The Midland Company's record-breaking 2006 financial results would strongly suggest that we continue to move in the right direction, with consolidated revenues of \$789.3 million, consolidated net income of \$70.7 million and diluted earnings per share of \$3.60.

In 2006, The Midland Company clearly achieved Beyond Standard results, as we continued to harvest the benefits of our transformation from primarily a point-of-sale manufactured housing insurance company to a multi-line, specialty property and casualty leader. Even though hurricanes took a much appreciated hiatus in 2006, our record-breaking financial results derived more from the diligent execution of our strategic plan than from good fortune.

One testament to the soundness of our long-term plan is our ability to effectively map today's results to strategies and actions implemented two or three years ago such as: proper positioning of our recreational casualty products allowing us to focus on growth while maintaining profitability; expansion of our site built dwelling product line; rating segmentation and development of non-admitted products to expand our markets; and, investment in the infrastructure of our Financial Institutions Division to help reinforce already strong bonds with key business partners and forge new relationships. The conscious implementation of these strategies contributed to double-digit growth in our insurance operations in 2006.

And, even as the manufactured housing industry continued to search for solutions that would rekindle dormant consumer demand and trigger a turnaround in new home shipments, we achieved premium growth and strong profits in our flagship line of business. Often lost in any retrospective of our company's success is the profit contribution of our commercial products ... a contribution that is remarkably significant relative to the volume of commercial premium we write and the corporate resources allocated to its development.

M/G Transport, Midland's niche river transportation company, continued to represent slightly more than 6 percent of Midland's top line revenues and had a banner year in 2006, achieving 18.1 percent growth on revenue of \$49.8 million and 34.8 percent return on beginning equity.

The backdrop upon which the insurance industry entered 2006 could arguably be characterized as an environment of increasing commoditization, regulatory pressure, market consolidation and slow growth. And, that is what makes Midland's 2006 performance so gratifying. Our results bear testament to the viability of our strategies and the resourcefulness of our partners in coping with those industry tendencies to produce consistently Beyond Standard outcomes. We are committed to achieving our financial objectives regardless of prevailing industry conditions, and we are able to deliver on that commitment.

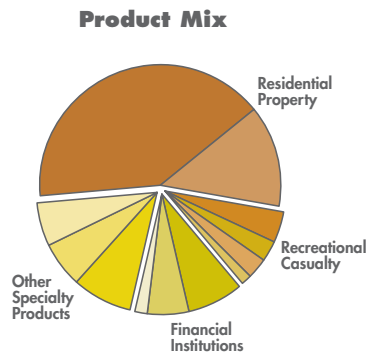
### FID LEADS THE WAY TO 11.0 PERCENT GROWTH IN GROSS WRITTEN PREMIUM

American Modern's gross written premium for 2006 reached a record \$831.8 million compared to \$749.5 million in 2005, an 11.0 percent increase. Included in this record number is an 11.9 percent increase in the property and casualty gross written premium to a record \$780.8 million, largely on the strength of significant premium growth in our Financial Institutions Division (FID).

Manufactured housing and site built dwelling insurance, our residential property lines of business, grew 1.9 percent and 22.2 percent, respectively, in 2006, with manufactured housing direct and assumed premiums increasing to \$337.8 million and site built dwelling rising to \$105.6 million. In addition to the introduction of a new specialty dwelling insurance product in many states in 2006, the framework for continued growth in these core lines resides, in great measure, in the effective expansion of rating segmentation strategies and our non-admitted product offering.

Our recreational casualty lines of business — motorcycle, watercraft, recreational vehicle, classic auto and snowmobile — collectively yielded \$94.3 million in written premiums in 2006. And, there were positive signs for the future, as pricing stability, enhancements to our evolving modernLINK<sup>®</sup> system and an increase in targeted marketing activities helped fuel a healthy 17.2 percent increase in quoting activity in our motorcycle and recreational vehicle products, a harbinger of new business growth in our recreational casualty lines. These factors also contributed to a 4.9-point increase in recreational casualty policy retention in 2006, another positive indicator of future growth.

In 2006, our policies in force rose nearly 5 percent, largely on the strength of increases in FID's Mortgage Fire and Preferred Renters products. Mortgage Fire written premium increased 96.0 percent to \$61.6 million. Late in 2005, FID introduced a Preferred Renters product which added more than \$10 million in written premium in 2006. In addition, the strategic acquisition of Southern Pioneer Life Insurance Company expanded the reach of our Credit Life operations and helped further diversify our book of business, adding credibility in the lender channel to a line that had labored under regulatory pressures in recent years.



(dollars in millions)

<b>Residential Property (54%)</b>
Manufactured Housing - \$337.8
Dwelling Fire and Other - \$111.5
<b>Recreational Casualty (11%)</b>
Motorcycle - \$35.7
Watercraft - \$22.1
Recreational Vehicle - \$24.8
Collector Car and Snowmobile - \$11.7
<b>Financial Institutions (15%)</b>
Mortgage Fire - \$61.6
Collateral Protection - \$46.3
Debt Cancellation and Other - \$14.2
<b>Other Specialty Products (20%)</b>
Excess & Surplus Lines - \$66.5
Credit Life and Related - \$51.0
All Other - \$48.6

Our broad and deep specialty insurance product platform establishes the foundation of our profit and growth strategies and has us well positioned in the specialty insurance marketplace.

### 93.8 PERCENT COMBINED RATIO DEMONSTRATES STRENGTH

The unprecedented devastation caused by hurricanes Katrina, Rita and Wilma in 2005 was mercifully absent in 2006. Even though the pendulum swung, gratefully, toward the opposite end of the catastrophe spectrum, increases in reinsurance costs still applied considerable pressure on profits. By taking decisive actions in early 2006 to control catastrophe exposure and mitigate risk, we were able to partially offset these reinsurance increases. However, reinsurance costs will continue to impact profits in 2007 and beyond, as reinsurers move to recover from record losses in 2005.

Despite increased reinsurance costs, our insurance operations achieved a 93.8 percent combined ratio in 2006. Our catastrophe loss ratio of 5.2 percent, as compared to 7.9 percent in 2005, played an important part in our success. While we cannot predict what Mother Nature will throw at us in any given year, we can and do moderate the impact of her whims by expertly managing our concentrations of exposure, business partner relationships and risk mitigation techniques. But, in addition to relatively benevolent weather patterns, we saw many positive signs of the underlying strength of our underwriting and pricing strategies.

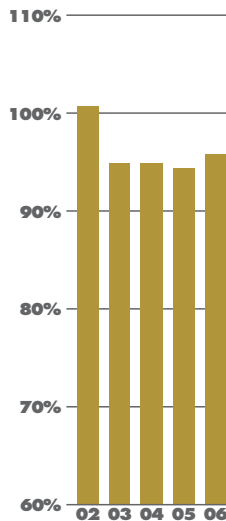
Our strategic imperatives continued to direct our attention and resources toward achieving operational effectiveness, but without losing our focus on strategic positioning and execution. While Midland achieved record financial results, our goal in 2007 and beyond is to continue to manage our products, rating segmentation and service levels in ways that will allow us to extend our competitive reach into additional segments of our target markets. Planned delivery of important enhancements to our online modernLINK<sup>®</sup> system will play an important role in achieving that goal, as will steadfast adherence to other strategic imperatives that center on expense reduction, enhancement of our product offering, maximizing market awareness and optimization of our distribution platform.

### PRODUCTS, MARKETING AND SERVICES HELP ACHIEVE LONG-RANGE GOALS

An old adage claims that “familiarity breeds contempt.” However, in the marketplace we operate in every day, familiarity — when coupled with product diversity, competitive pricing and efficient user interfaces — generally leads to consumer preference rather than contempt. We have made significant progress in 2006 on all three fronts.

The introduction of a new Specialty Dwelling policy has added an important product to our agents’ tool belt to target opportunities that fall outside the standard carriers’ risk tolerance. A sustained and expanded marketing campaign has increased unaided awareness of American Modern by 27.8 percent in less than two years, giving us more top-of-mind presence with the customer service representatives who make placement decisions each day. And, scheduled 2007 delivery of online policy

**American Modern's  
Manufactured Housing  
5-Year  
Combined  
Ratio**



American Modern's manufactured housing GAAP combined ratio remained strong in 2006. Rate adequacy, stable fire loss ratios and effective exposure management contributed to these sound results.

administration and access to additional products via modernLINK<sup>®</sup> will continue to help translate that increased awareness and product availability into an easy choice of American Modern for specialty risks.

As a company grows, it can become a daunting task to simply maintain existing revenue levels, much less achieve ongoing double-digit growth. That is why we have invested heavily in customer retention programs as complementary companions to new business strategies. In 2006, these investments continued to deliver very positive returns, as we experienced significant improvement in our rolling-12-month retention rate. We have the gears in motion for a dramatic expansion of our successful Retention Assistance Plan for agents in 2007, which should continue to support our retention improvement objectives.


**A COMMITMENT TO SUPERIOR PERFORMANCE**

Aristotle told us that excellence is not an act, but a habit. For a company to achieve excellence, then, its performance in any given year is an inadequate yardstick of success. Performance must be repeatable, or it is an anomaly.

Of course, superior performance can manifest itself in many ways. And, just as the enthusiastic applause of an appreciative audience can coax an encore performance from a symphonic orchestra or world-class athlete, The Midland Company's enduring commitment to Beyond Standard performance is personified in the confidence our shareholders, customers, producers and associates have placed in us over the years.

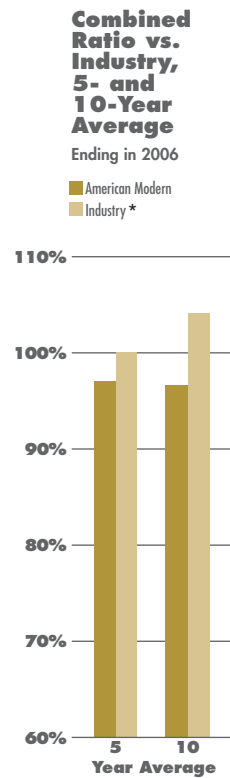
The road to success is never clearly mapped out. It always has its share of bumps, congestion, detours and surprises. But, it almost always passes through a place in the mind that has made a commitment to a set of inviolable values, sheer determination and a shared vision for the future. Our long-time director and friend, Glenn E. "Bo" Schembechler, epitomized that vision. He has been, and will continue to be, a source of inspiration to us. And, even though we will miss him dearly, we will continue to embrace the principles of leadership and greatness that gave Bo a sustainable competitive advantage in everything he undertook.

As always, we are grateful for your continued support of Midland's ongoing success. With your commitment, we are confident in our ability to continue delivering on our promise of Beyond Standard performance in the years ahead.

  
**Joseph P. Hayden III**  
 Chairman and  
 Chief Operating Officer

  
**John W. Hayden**  
 President and  
 Chief Executive Officer

March 7, 2007



American Modern has consistently outperformed industry profitability over the past five and ten-year periods. Its superior performance underscores the company's strong specialty expertise.

\*A.M. Best

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## FAREWELL TO A FRIEND: A Tribute to Glenn E. “Bo” Schembechler



**Glenn E. “Bo” Schembechler, 1929 – 2006**

The passing of legendary Glenn E. “Bo” Schembechler made national news last November. The winningest football coach in University of Michigan history was known as a tenacious competitor. During Bo’s 21 years at the helm, Michigan won thirteen Big Ten championships and went to ten Rose Bowls. Mr. Schembechler was less known for another important role: as a member of the board of directors of The Midland Company since 1981.

For all his success and fame, Bo never strayed far from the strong roots and relationships he developed in his college and early coaching days at Miami University, where he developed a life-long friendship and bond with Midland’s now retired Chairman and CEO J.P. “Joe” Hayden, Jr.

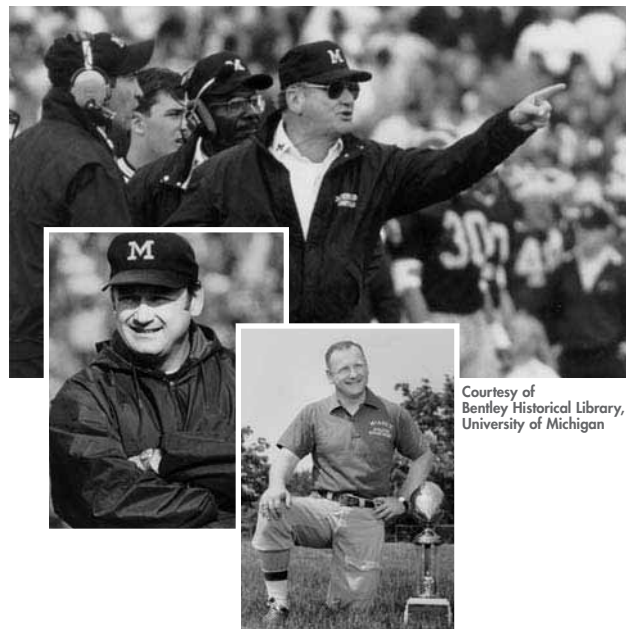
A true legend in every sense of the word, Bo stands among college football’s greatest coaches ever. In a lifetime that never took him too far from the athletic arena he loved, Bo built an enviable portfolio of successes. And, with that success came

the kind of insight and wisdom that characterized his many contributions to our company’s remarkable evolution over the years.

The Midland Company benefited greatly from our 25-year association with him. At Midland, our goal is to consistently bring Beyond Standard products, services and integrity to each of our business and customer relationships. In doing so, we are proud to emulate a man who truly personified our values. A man who epitomized hard work, fair play and an inspirational competitiveness that could move a team to victory against daunting odds. Bo was, in every way, Beyond Standard.

In memory of our friend and associate, Midland has made a cornerstone contribution to the Bo Schembechler “Heart of a Champion” Research Fund at the University of Michigan. We hope others will do the same to help perpetuate the legacy of caring and sharing that endeared Bo to millions: former players, coaches, friends, and fans during a lifetime of remarkable achievement. It goes without saying that he made a difference in athletics. But, more importantly, he made an indelible difference in the lives of those he touched and on our company.

He will be missed.



Courtesy of Bentley Historical Library, University of Michigan

# BEYOND STANDARD PERFORMANCE

“Standard” has been defined as “something considered by an authority or by general consent as a basis of comparison; an approved model.”\*

At The Midland Company, simply meeting a standard is not nearly enough. Whether it is in terms of product offerings, value, customer service, claims, technology or relationships with our business partners, we measure ourselves on whether and how well we achieve Beyond Standard results.

We are focused on offering a depth and breadth of products not available in the standard market. We work closely with our agents to ensure mutual success. Our customers have learned to rely on us for exceptional claims and customer service. All of these factors drive our financial success.

Our objective is continuous improvement, to consistently find new and better ways of doing everything we do. We pursue this goal because our customers will raise the bar if we do not. The marketplace will continue to evolve. And, our competitors will concede us nothing. Excellence is a moving target.

\*Dictionary.com Unabridged (v 1.1)  
Based on the Random House Unabridged Dictionary,  
© Random House, Inc. 2006

# BEYOND STANDARD FINANCIAL

Record financial results for Midland in 2006 came on the heels of previous record results in 2005. In an industry that is almost synonymous with cyclicalities, Midland has consistently delivered impressive results.

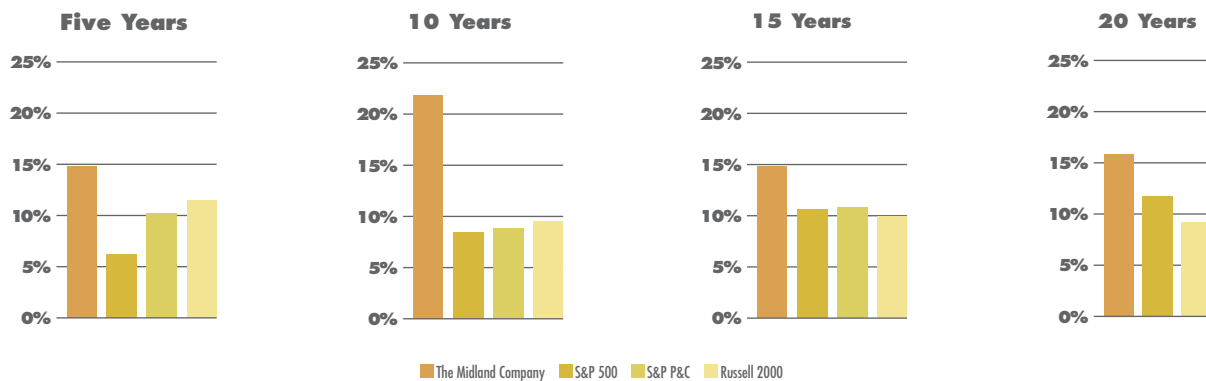
Over the last five, 10, 15, and 20 years, Midland has outperformed the S&P 500, S&P Property & Casualty, and Russell 2000 indices. Over these same periods, we have produced double-digit growth in the market value and book value per share of Midland stock. Our objective is to produce 12–15 percent return on beginning equity by targeting a 95.5 percent combined ratio.

Midland continues to assert its leadership in the specialty property and casualty marketplace, underscored by the ability to execute profit and growth strategies while maintaining underwriting discipline and rate adequacy. For the eighth consecutive year, Midland's American Modern

Insurance Group was named as one of Ward's Top 50 Property-Casualty Insurance Companies, and in 2006, Midland was added to the NASDAQ Financial-100 Index (IXFIN), which includes 100 of the largest domestic and international financial securities listed on NASDAQ based on market capitalization.

*The company's financial performance has been clearly Beyond Standard not only last year, but for decades. In an industry that is almost synonymous with cyclicalities, Midland has consistently delivered impressive results.*

## Total Return to Shareholders



For periods ending December 31, 2006

# PERFORMANCE



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# BEYOND STANDARD PRODUCT

American Modern's success in providing Beyond Standard products is the result of developing a thorough understanding of the market. It is about carefully listening to customers and collaborating with our agency partners to craft product offerings that meet specific market needs. Our product developers log countless miles on the road, meeting with top producers to make sure we are offering products that meet the needs of the ever-changing marketplace.

We focus on specialty markets, zeroing in on overlooked or underserved niches, and provide finely-tuned products that standard carriers will not — or can not — provide. Yet, American Modern goes even further, not only in terms of coverages, but also in developing rates that match the risk profiles of various customer segments. We specialize in what some carriers might view as ancillary or "add-on" business, giving us an opportunity to provide products that mutually benefit the company and our customers.

Advanced information technology gives us the ability to analyze an individual risk in terms of financial stability, demographic profile, and physical characteristics of the risk and then generate an accurate, customized quote in less than a minute. This highly scientific analysis ensures that both American Modern and our customers get "the right rate for every risk."

## **AT HOME WITH RESIDENTIAL PROPERTY**

Historically, residential property, including manufactured homes and site built dwellings, has

represented the largest segment of American Modern's business. That is still true today. Although our product mix has shifted notably in the past few years, we remain fully committed to the residential property marketplace. During 2006, the company produced a record number of product revisions in response to the changing needs of the mobile and manufactured home marketplace.

In the site built dwelling sector, specialty homeowners products, such as dwelling fire protection, are being well received. Creative new products that meet customer requirements in an ever-widening geographic sphere promise to yield Beyond Standard performance.

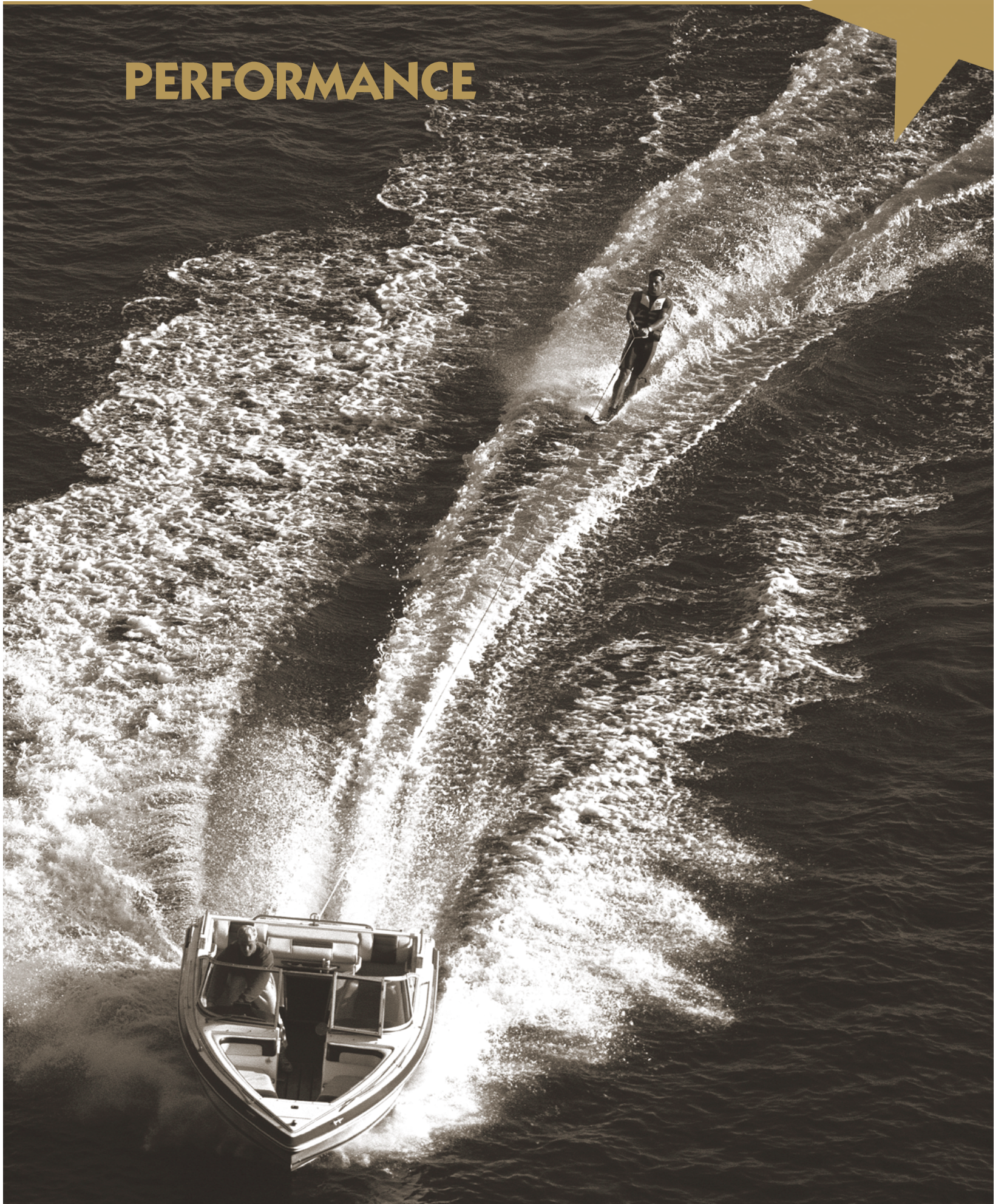
## **MOVING FORWARD WITH RECREATIONAL CASUALTY**

American Modern's diverse line of recreational casualty products continues to ride the wave of enthusiasm for leisure time activities in the United States. On the road, off the road, in the water, or in the snow, we help owners insure everything from ATVs and motorcycles to boats to recreational vehicles to snowmobiles to personal watercraft to collectible automobiles.

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*We focus on specialty markets, zeroing in on overlooked or underserved niches, and provide finely-tuned products that standard carriers will not — or can not — provide.*

# PERFORMANCE



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# BEYOND STANDARD PRODUCT

## (CONTINUED)

In 2006, we introduced a revitalized motorcycle program that has kick-started market interest. An aggressive marketing effort will bolster our motorcycle program throughout fiscal 2007.

### **BANKING ON FINANCIAL PRODUCTS**

American Modern significantly enhanced its Financial Institutions Division (FID) in 2006 with the acquisition of Southern Pioneer Life, a company that has focused on credit life insurance since 1980. In 2006, we also marked the first full year for our preferred renters product, which is offered through owners of large real estate investment trusts, each of which is comprised of literally thousands of units. The company enjoys significant penetration in this select distribution channel, which means enhanced opportunity for growth and mitigation of any risk of adverse selection.

FID provides a variety of products and services to banks, credit unions, and a variety of other financial institutions. In addition to credit life insurance, lenders look to us for mortgage fire, collateral protection, vendor's single interest, and flood insurance, in addition to debt cancellation protection.

### **PROTECTING COMMERCIAL PROPERTY**

American Modern's commercial property insurance program performed well Beyond Standard in its core business: providing "open lot" coverage for retailers of recreational vehicles and manufactured homes in addition to manufactured housing community

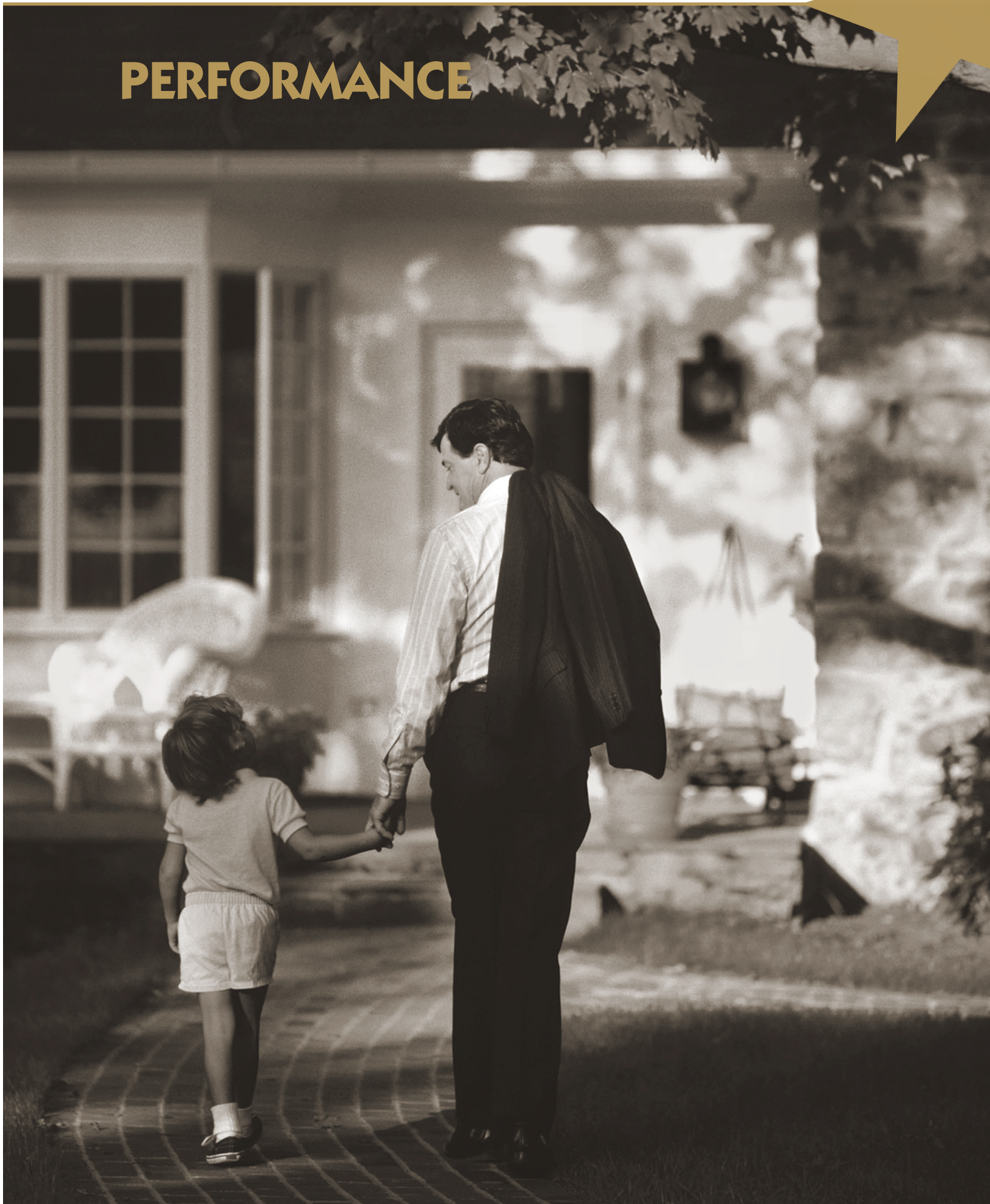
property protection. The retail protection program was expanded in 2006 to include loss of economic value insurance to cover potential inventory losses from storms and other perils. This is another example of the kinds of insurance programs American Modern develops that are custom tailored to our unique customer base. The company's partnership with London-based Bell & Clements continues its success in providing excellent property and liability coverage to property owners and businesses ranging from shopping centers to restaurants and retail shops throughout the U.S. on a non-admitted basis.

American Modern's diversified portfolio of specialty insurance products and services is clearly Beyond Standard, providing opportunities that are mutually beneficial for American Modern as well as our customers.

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*The Financial Product Division (FID) provides a variety of products and services to financial institutions that look to us for credit life insurance, mortgage fire insurance, collateral protection insurance, vendor's single interest, debt cancellation, and flood insurance.*

# PERFORMANCE



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# BEYOND STANDARD SERVICE

It has been said that there is no greater affirmation of a company's excellence than a pleased customer. American Modern goes well Beyond Standard to please customers with a depth and breadth of *customer care* services. Our overriding objective is to exceed customer expectations during every interaction. For American Modern, the word "customer" can denote anyone from a policyholder or claimant to any of the thousands of producer/business partners in our national, multi-channel distribution network.

American Modern customer service representatives handle 1.5 million policyholder contacts a year regarding the status of their policies, making minor changes, and arranging payments.

## **AUGMENTING AGENCY FUNCTIONS**

In 2006, the company launched a major new agency services initiative, allowing our business partners to effectively outsource many aspects of the customer service experience. Agencies contract with American Modern for a host of services, including quoting and sales, policy servicing, book conversions, account reporting, lead prospecting, policyholder retention, product training, and marketing tools for the company's complete line of property and casualty products. A team of 130 professionals, more than half of whom hold agents' licenses, offers high touch personalization to create a satisfying customer experience.

## **TRACKING LOANS WITH AMERITRAC**

Financial institutions rely on American Modern's Ameritrac system to make certain that the collateral on the loans they make is always insured. The system

tracks the status of insurance on the collateral of all sorts of loans from residential property to vehicles and personal property loans and leases, capturing insurance information supplied by more than 1,200 insurance carriers. In 2006, the first full year in which new OCR/imaging technology was deployed, Ameritrac more than doubled weekly productivity in the handling of insurance documents.

## **PROMPT AND FAIR CLAIM SERVICE**

We believe American Modern's commitment to claim service goes far Beyond Standard and is a key ingredient in the company's formula for success. A highly experienced team of more than 300 specially trained claim adjusters works with policyholders throughout the country to expedite the claim process and help customers quickly recover from the losses they experience. We have a keen understanding of how disruptive a catastrophe can be and work to resolve claims expeditiously, so that our customers can get on with their lives. Catastrophe specialists are always on standby, strategically positioned, and ready at a moment's notice to react immediately to storm incidents across the United States.

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*Our overriding objective is to exceed customer expectations during every interaction, whether that "customer" is a policyholder or one of the thousands of producers in our national, multi-channel distribution network.*

# PERFORMANCE



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# BEYOND STANDARD TECHNOLOGY

The impact of modern information technology is ubiquitous: expanding horizons, empowering productivity, and enriching daily life. The application of technology to Midland's American Modern Insurance Group business is all about enabling us to deliver a differentiating level of convenience and ease for our partners and customers to do business with us.

modernLINK<sup>®</sup>, the company's homegrown suite of applications that helps agents perform a host of services online via the Internet, is having a profound and measurable impact. In 2006, the system received the "Best in Class" technology award from *Computerworld* magazine's IT Leaders Conference in recognition of its strategic application of information technology.

More than 95 percent of American Modern's general agents and independent agents are now set up to use modernLINK for policy quoting, issuance, inquiry, and payment applications. The system also scores high in user satisfaction.

"modernLINK is as good or better than any system I have worked with. It makes it so easy to do business with American Modern, it's almost scary!" — Bruce Barnes, President, Hawkeye Special Risks, Payson, Arizona

"Using modernLINK makes our jobs a lot easier in terms of quoting, and the resulting general flow of paperwork is a lot more efficient." — Laura Wilson, President, Western Insurance Agency, League City, Texas

"Instead of our group having to fax quotes to our agents or generate quotes in modernLINK on their behalf, the agents are now quoting from modernLINK themselves, which is a huge time-saver." — Greg Bauke, President, Specialty Underwriters Group, Cincinnati, Ohio

The value modernLINK provides helps ensure that American Modern and its partners will continue to expand and evolve with the introduction of "The Next Generation" of modernLINK functionality. The system design includes easier navigation, an ever-expanding array of tools for interactive training, quick and accurate quoting, access to marketing tips and sales collateral materials, and a greatly enhanced agency management sub-system.

modernLINK is backed by a dedicated and responsive system support team that serves as a "help desk" to American Modern partners throughout the country. The team provides everything from "tips and tricks" to the identification and resolution of system performance issues. modernLINK users have found that help is just an email or phone call away. By resolving user questions quickly and efficiently, the system support team helps improve office productivity, reduce costs, and enhance user satisfaction.

The effective implementation of technology in service of business objectives is an increasingly relevant deliverable within the insurance industry. And, modernLINK clearly strives to exceed that standard.

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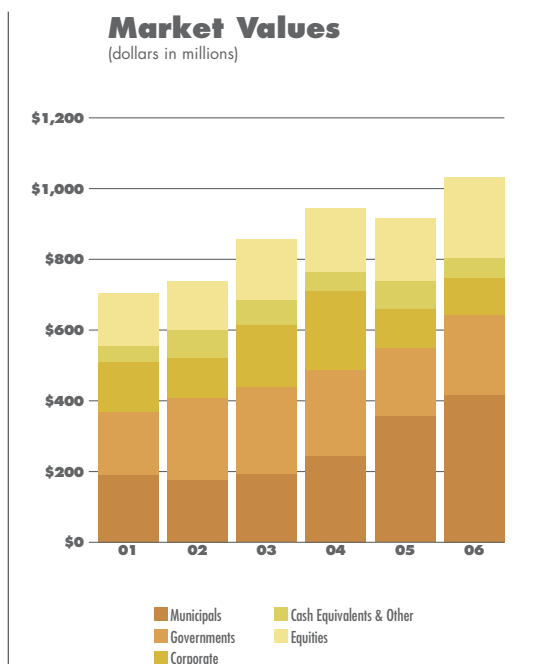
*modernLINK<sup>®</sup>, a suite of applications for policy quoting, issuance, inquiry, and payment applications, received the "Best in Class" technology award from Computerworld magazine's IT Leaders Conference in recognition of the strategic use of information technology.*

**PERFORMANCE**



## INVESTMENT PORTFOLIO

# High Quality Diversified Investment Portfolio.



### Portfolio Profile December 31, 2006

**78% Fixed Income**  
**(\$801.7 million)**

- "AA" average quality
- 5.0 years average duration

**22% Equities**  
**(\$229.7 million)**

## ANNUALIZED TOTAL RETURN

(Total Return is the rate of return on a portfolio that takes into consideration both interest income and dividends plus the change in the market value.)

	Periods Ending December 31, 2006		
	1 Year	3 Years	5 Years
<b>EQUITIES:</b>			
American Modern – Composite	21.6%	11.6%	11.4%
American Modern – Excluding Investment in US Bancorp	19.1%	12.4%	7.7%
American Modern – US Bancorp only	26.4%	11.7%	15.8%
S&P 500	15.8%	10.4%	6.2%
<b>FIXED INCOME TOTAL RETURN</b>	<b>5.0%</b>	<b>4.0%</b>	<b>5.2%</b>
<b>FIXED INCOME PRE-TAX EQUIVALENT YIELD AS OF DECEMBER 31, 2006</b>	<b>5.9%</b>		

## M/G TRANSPORT SERVICES, INC.

# A Beyond Standard Niche River Transportation Business.

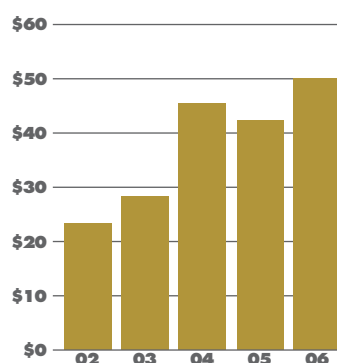
M/G Transport (M/G), Midland's niche river transportation subsidiary, had record net income for fiscal 2006 of \$5.1 million compared to \$3.2 million in 2005. This record profit resulted in a 34.8 percent return on beginning equity. Revenues for 2006 were \$49.8 million, an 18.1 percent increase over the \$42.2 million in 2005, reflecting increased freight rates and full equipment utilization. M/G's gross margin increased to 33.5 percent in 2006 compared to 31.5 percent in 2005. During 2006, M/G recorded a total of 2,969 barge loadings, of which 19.1 percent were sub-contracted out due to full utilization of our fleet.

As previously reported, M/G contracted to purchase 100 barges in 2006 and 2007 to provide needed additional capacity for the fleet and to eventually replace about 35 aging barges. During 2006, M/G took delivery of 75 barges. Five more barges were delivered to M/G during the first week of 2007, with the remaining 20 barges scheduled for delivery later in 2007. Of the 80 barges delivered in 2006 and early 2007, M/G purchased 20 with cash from operations while the remaining 60 were acquired under various leasing arrangements. As of December 31, 2006, M/G was operating a total fleet of 303 barges, an increase of 28.4 percent over the 236 in the fleet at the end of 2005.

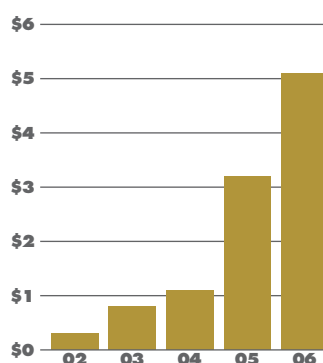
M/G continues to operate primarily on the Lower Mississippi River south of Baton Rouge and on the Gulf Intracoastal Waterway west from the New Orleans area to the Houston area. The company continues to serve large industrial accounts moving only dry cargoes — primarily petroleum coke, barite, and sugar.



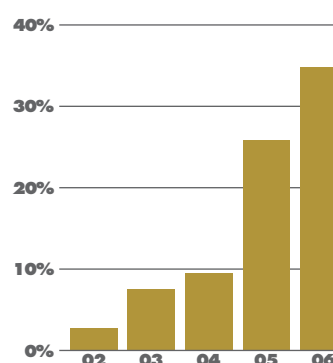
**Revenues**  
(dollars in millions)



**Net Income**  
(dollars in millions)



**Return on Beginning Equity**



## SIX YEAR FINANCIAL SUMMARY DATA

THE MIDLAND COMPANY AND SUBSIDIARIES

(Amounts in thousands, except per share data)	For the Years Ended December 31,					
	2006	2005	2004	2003	2002	2001
<b>Income Statement Data</b>						
Revenues:						
Premiums earned	\$ 675,864	\$ 631,864	\$ 677,584	\$ 638,038	\$ 577,668	\$ 508,233
Other insurance income	12,929	12,600	13,780	14,064	13,756	12,971
Net investment income	42,223	40,519	37,165	33,279	35,899	34,198
Net realized investment gains (losses) <sup>(a)</sup>	8,445	6,262	9,933	4,566	(6,900)	2,023
Transportation	49,807	42,185	45,379	28,240	23,285	34,826
Total	789,268	733,430	783,841	718,187	643,708	592,251
Costs and Expenses:						
Losses and loss adjustment expenses	307,503	286,662	348,611	392,232	341,015	292,188
Commissions and other policy acquisition costs	209,719	198,585	201,155	177,622	169,477	145,777
Operating and administrative expenses <sup>(d)</sup>	127,236	112,329	108,536	87,714	80,985	80,316
Transportation operating expenses	41,792	36,986	43,266	26,645	22,641	32,898
Interest expense	5,164	5,967	5,169	3,742	3,849	4,368
Total	691,414	640,529	706,737	687,955	617,967	555,547
Income Before Federal Income Tax and Cumulative Effect of Change in Accounting Principle	97,854	92,901	77,104	30,232	25,741	36,704
Provision for Federal Income Tax	27,159	27,575	22,866	6,956	5,437	9,482
Income Before Cumulative Effect of Change in Accounting Principle	70,695	65,326	54,238	23,276	20,304	27,222
Cumulative Effect of Change in Accounting Principle—Net <sup>(c)</sup>	—	—	—	—	(1,463)	—
Net Income <sup>(d)</sup>	\$ 70,695	\$ 65,326	\$ 54,238	\$ 23,276	\$ 18,841	\$ 27,222
Basic Earnings (Losses) Per Share of Common Stock <sup>(b)(d)</sup> :						
Income Before Cumulative Effect of Change in Accounting Principle	\$ 3.70	\$ 3.46	\$ 2.91	\$ 1.34	\$ 1.17	\$ 1.58
Cumulative Effect of Change in Accounting Principle <sup>(c)</sup>	—	—	—	—	(0.08)	—
Total	\$ 3.70	\$ 3.46	\$ 2.91	\$ 1.34	\$ 1.09	\$ 1.58
Diluted Earnings (Losses) Per Share of Common Stock <sup>(b)(d)</sup> :						
Income Before Cumulative Effect of Change in Accounting Principle	\$ 3.60	\$ 3.37	\$ 2.83	\$ 1.30	\$ 1.14	\$ 1.51
Cumulative Effect of Change in Accounting Principle <sup>(c)</sup>	—	—	—	—	(0.08)	—
Total	\$ 3.60	\$ 3.37	\$ 2.83	\$ 1.30	\$ 1.06	\$ 1.51
Cash Dividends Per Share of Common Stock <sup>(b)</sup>	\$ 0.245	\$ .225	\$ .205	\$ .190	\$ .175	\$ .160

THE MIDLAND COMPANY AND SUBSIDIARIES

(Amounts in thousands, except per share data)	For the Years Ended December 31,					
	2006	2005	2004	2003	2002	2001
<b>Balance Sheet Data</b>						
Total Cash and Marketable Securities	\$ 1,036,436	\$ 950,464	\$ 978,296	\$ 848,708	\$ 745,733	\$ 715,295
Total Assets	1,569,528	1,428,113	1,364,684	1,192,216	1,101,136	1,060,212
Total Debt	108,445	111,771	115,906	95,842	90,401	84,141
Unearned Insurance Premiums	445,324	395,007	390,447	383,869	406,311	403,855
Loss Reserves	221,639	254,660	232,915	204,833	164,717	148,674
Shareholders' Equity	574,746	484,377	432,276	356,058	308,908	291,876
Book Value Per Share <sup>(b)</sup>	\$ 29.90	\$ 25.54	\$ 22.98	\$ 20.18	\$ 17.59	\$ 16.53
Common Shares Outstanding <sup>(b)</sup>	19,224	18,964	18,807	17,643	17,566	17,660
<b>Other Data</b>						
AMIG's Property and Casualty Operations						
Direct and Assumed Written Premiums	\$ 780,795	\$ 697,930	\$ 722,394	\$ 663,972	\$ 588,243	\$ 555,548
Net Written Premium	678,107	619,267	671,985	616,709	561,515	523,105
M/G Transport's Transportation Operations						
Net Revenues	\$ 49,807	\$ 42,185	\$ 45,379	\$ 28,240	\$ 23,285	\$ 34,826
Net Income	5,108	3,166	1,090	815	296	1,079
Total Assets	51,435	50,400	38,869	30,990	22,469	24,952
Shareholders' Equity	18,484	14,676	12,261	11,446	10,805	10,509
<b>Footnotes:</b>						
(a) Net Realized Investment Gains (Losses) in 2006, 2005, 2004, 2003, 2002 and 2001 include the effect of SFAS 133 adjustments of \$1.0 million, \$0.4 million, \$0.8 million, \$0.8 million, \$(0.2) million and \$1.1 million, respectively.						
(b) Previously reported share information has been adjusted to reflect a 2-for-1 stock split effective July 17, 2002.						
(c) On January 1, 2002, the Company adopted SFAS 142 and recorded an impairment charge related to goodwill of \$1.5 million, net of tax of \$0.8 million.						
(d) The Company adopted SFAS 123(R) in 2005 which increased stock option expense \$2.5 million and \$1.9 million in 2006 and 2005, respectively. Net income (after tax) was reduced by \$1.6 million and \$1.2 million, or \$0.08 and \$0.06 per share (diluted and basic), in 2006 and 2005, respectively. Prior year results were not restated.						

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# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE MIDLAND COMPANY AND SUBSIDIARIES

## Forward Looking Statements

Certain statements made in this report are forward-looking and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, certain discussions relating to future revenue, underwriting income, premium volume, investment income and other investment results, business strategies, profitability, liquidity, capital adequacy, anticipated capital expenditures and business relationships, as well as any other statements concerning the year 2007 and beyond. In some cases you can identify forward-looking statements by such terms as "may," "will," "should," "could," "would," "expect," "plan," "intend," "anticipate," "believe," "estimate," "project," "predict," "potential," "likely," "target" and similar expressions or the negative versions of such expressions. These forward-looking statements reflect The Midland Company's current views about future events, are based on assumptions and are subject to known and unknown risks and uncertainties that may cause results to differ materially from those anticipated in those statements. Many of the factors that will determine future events or achievements are beyond Midland's ability to control or predict. Factors that might cause results to differ from those anticipated include, without limitation, adverse weather conditions, changes in underwriting results affected by adverse economic conditions, fluctuations in the investment markets, changes in the retail marketplace, changes in the laws or regulations affecting the operations of the Company or its subsidiaries, changes in exposures to assessments and surcharges for guarantee funds, second injury funds and other mandatory pool arrangements, changes in the business tactics or strategies of the Company, its subsidiaries or its current or anticipated business partners, the financial condition of the Company's business partners, acquisitions or divestitures, changes in market forces, litigation and the other risk factors that have been identified in the Company's filings with the SEC, any one of which might materially affect the operations of the Company or its subsidiaries. Any forward-looking statements speak only as of the date made. We undertake no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made. You should read this document and the documents referenced herein and filed as exhibits herewith completely and with the understanding that Midland's actual future results may be materially different from what Midland expects. Midland qualifies all of its forward-looking statements by these cautionary statements.

## Introduction

The Midland Company ("Midland" or the "Company") is a highly focused provider of specialty insurance products and services through its American Modern Insurance Group, Inc. ("AMIG" or "American Modern") subsidiary, which contributes approximately 94 percent of the company's revenues. The Company also maintains an investment in a niche river transportation business, M/G Transport Services Inc. The Company has divided its insurance products into four distinct groups: residential property, recreational casualty, financial institutions, and all other insurance products. The discussions of "Results of Operations" and "Liquidity, Capital Resources and Changes in Financial Condition" address these four reportable insurance segments and our transportation business. A summary description of the operations of each of these segments is included below.

Our residential property segment includes primarily manufactured housing and site-built dwelling insurance products. Approximately 41% of American Modern's property and casualty and credit life gross written premium relates to physical damage insurance and related coverages on manufactured homes, generally written for a term of 12 months with many coverages similar to homeowner's insurance policies. Our recreational casualty segment includes specialty insurance products such as motorcycle, watercraft, recreational vehicle, collector car and snowmobile. Our financial institutions segment includes specialty insurance products such as mortgage fire, collateral protection and debt cancellation, which are sold to financial service institutions or their customers. The all other insurance segment includes products such as credit life, long-haul truck physical damage, commercial, excess and surplus lines and also includes the results of our fee producing subsidiaries.

Our specialty insurance operations are conducted through our wholly-owned American Modern subsidiary which controls eight property and casualty insurance companies, seven credit life insurance companies, three licensed insurance agencies and three service companies. American Modern is licensed, through its subsidiaries, to write insurance premiums in all 50 states and the District of Columbia.

M/G Transport Services, Inc. and MGT Services, Inc. (collectively M/G Transport) operates a fleet of dry cargo barges for the movement of dry bulk commodities such as petroleum coke, ores, barite, sugar and other dry cargoes primarily on the lower Mississippi River and its tributaries and manages river transportation equipment owned by others on a fee based arrangement.

## Overview of Recent Trends

### Exposure Management

American Modern's catastrophe reinsurance program is a significant aspect of our exposure management. Our 2006 catastrophe reinsurance structure was similar to the 2005 program with a \$3.0 million increase in retention, from \$7 million to \$10 million, and the purchase of an additional \$40 million of protection on top of our previous \$110 million cover. Due to the volatile weather patterns of 2005, we absorbed a significant increase in our base reinsurance cost in 2006 that nearly doubled the base cost of 2005. This increase, along with the additional cover, adversely impacted our 2006 pre-tax earnings by approximately \$12.0 million, or \$0.40 per share (diluted). We have already begun efforts to recoup these costs through appropriate rate increases, commission adjustments and/or product changes. However, this is a process that takes some time, including additional time after state approvals to get the new rates and product changes into place within the renewal book and earned premium. These efforts produced minimal benefit to our 2006 profits, and likely will not be fully realized until 2007.

Our 2007 catastrophe reinsurance program is similar to the 2006 structure, but includes an additional \$50 million layer of protection on top of our previous \$150 million cover. The cost of our base catastrophe reinsurance program, which includes the purchase of the additional cover, will adversely impact our 2007 earnings by approximately \$0.16 per share (diluted) as compared to 2006.

*Diversification—Growth of Non-Manufactured Housing Products*

American Modern has continued to experience significant premium growth in non-manufactured housing product lines, including site built dwelling, mortgage fire, credit life and excess and surplus lines. Collectively, our non-manufactured housing direct and assumed written premiums grew 22.6% in 2006 compared to 2005. Non-manufactured housing products represented 59% and 64% of American Modern's direct and assumed written premiums and related pre-tax profit, respectively, during 2006.

## RESULTS OF OPERATIONS YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

### Insurance

#### Overview of Premium Volume

The following chart shows American Modern's gross written premium, net written premium and net earned premium by business segment for the years ended December 31, 2006 and 2005 (in millions). Gross written premium, also described as direct and assumed written premium, is the amount of premium charged for policies issued during a fiscal period. Net written premium is the amount of premium that American Modern retains after ceding varying portions of its gross written premium to other insurance companies. Net earned premium is the amount included in our condensed consolidated statements of operations. Premiums for physical damage and other property and casualty related coverages, net of premium ceded to reinsurers, are considered earned and are included in the financial results on a pro-rata basis over the lives of the policies. Credit accident and health and credit life premiums are recognized as income over the lives of the policies in proportion to the amount of insurance protection provided. The portion of written premium applicable to the unexpired terms of the policies is recorded as unearned premium in our condensed consolidated balance sheets.

Business Segment	December 31, 2006		
	Gross Written Premium	Net Written Premium	Net Earned Premium
Residential Property	\$449.3	\$402.1	\$392.8
Recreational Casualty	94.3	92.7	95.5
Financial Institutions	122.1	112.7	103.8
All Other Insurance	166.1	86.8	83.8
<b>Total</b>	<b>\$831.8</b>	<b>\$694.3</b>	<b>\$675.9</b>

Business Segment	December 31, 2005		
	Gross Written Premium	Net Written Premium	Net Earned Premium
Residential Property	\$421.6	\$381.3	\$378.4
Recreational Casualty	100.5	98.2	103.3
Financial Institutions	79.1	70.8	78.4
All Other Insurance	133.3	77.1	71.8
<b>Total</b>	<b>\$734.5</b>	<b>\$627.4</b>	<b>\$631.9</b>

Gross written premium, net written premium and net earned premium increased 13.2%, 10.7% and 7.0%, respectively, in 2006 compared to 2005. The most significant contributors to the growth in premiums in 2006 were the mortgage fire, site-built dwelling, excess and surplus lines and credit life insurance products.

#### Residential Property

The following chart is an overview of the results of operations of the company's residential property segment (in 000's).

	December 31,		
	2006	2005	Change
<b>Residential Property</b>			
Direct and Assumed			
Written Premiums	\$449,270	\$421,631	6.6 %
Net Written Premiums	\$402,056	381,304	5.4 %
Net Earned Premium	\$392,762	\$378,402	3.8 %
Service Fees	6,124	5,651	8.4 %
Total Revenues	\$398,886	\$384,053	3.9 %
Income Before Taxes	\$ 42,554	\$ 45,755	
Combined Ratio	96.2%	95.4%	

The results from this segment are driven primarily by the manufactured housing and site-built dwelling products. Although the manufactured housing industry continues to be depressed, American Modern's diverse distribution channels have enabled gross written premiums related to this product to increase to \$337.8 million in 2006 compared to \$331.5 million in 2005. Site-built dwelling gross written premiums increased 22.2% to \$105.6 million in 2006 compared to \$86.4 million in 2005.

The manufactured housing combined ratio, including catastrophe losses, increased slightly to 95.8% in 2006 compared to 94.4% in 2005. Excluding catastrophe losses for both years, the combined ratio was 86.3% in 2006 compared to 84.7% in 2005. The increase in combined ratio was due to the substantial increase in American Modern's reinsurance program costs in 2006 compared to 2005 resulting from the significant hurricane activity in 2005. The site-built dwelling combined ratio improved to 97.6% in 2006 compared to 98.3% in 2005.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

THE MIDLAND COMPANY AND SUBSIDIARIES

### Recreational Casualty

The following chart is an overview of the results of operations of the company's recreational casualty segment (in 000's).

	December 31,		
	2006	2005	Change
<b>Recreational Casualty</b>			
Direct and Assumed			
Written Premiums	\$ 94,285	\$100,438	(6.1)%
Net Written Premiums	\$ 92,725	98,209	(5.6)%
Net Earned Premium	\$ 95,520	\$103,234	(7.5)%
Service Fees	1,751	2,373	(26.2)%
Total Revenues	\$ 97,271	\$105,607	(7.9)%
Income Before Taxes	\$ 10,186	\$ 12,693	
Combined Ratio	97.0%	96.6%	

Direct and assumed written premiums for our recreational casualty products decreased due primarily to the decreases of \$5.6 million and \$2.5 million for our watercraft and motorcycle products, respectively. The decrease in motorcycle direct and assumed written premiums was due primarily to the implementation in recent years of new underwriting modifications such as restrictions on certain types of coverages and implementation of a more sophisticated motorcycle make/model table to improve accuracy of class and identification of ineligible units. The decrease in watercraft direct and assumed written premiums was due primarily to underwriting actions taken to balance our coastal exposures. Although these actions are currently reducing our ability to grow these lines, we believe the recreational casualty products are now better positioned to provide profitable growth in the upcoming years.

### Financial Institutions

The following chart is an overview of the results of operations of the company's financial institutions insurance segment (in 000's).

	December 31,		
	2006	2005	Change
<b>Financial Institutions</b>			
Direct and Assumed			
Written Premiums	\$122,155	\$ 79,108	54.4 %
Net Written Premiums	112,658	\$ 70,817	59.1 %
Net Earned Premium	\$103,831	\$ 78,424	32.4 %
Total Revenues	\$103,831	\$ 78,424	32.4 %
Income Before Taxes	\$ 12,507	\$ 9,471	
Combined Ratio	92.9%	93.5%	

The increase in direct and assumed written premiums for our financial institutions insurance products was driven primarily by the mortgage fire product which increased \$30.2 million compared to the prior year. The increase in mortgage fire premiums is due to the signing of several new accounts throughout the year. Income increased for our financial institutions insurance products due to the mortgage fire profits generated from the increased written premiums.

### All Other Insurance

The following chart is an overview of the results of operations of the company's other insurance segment (in 000's).

	December 31,		
	2006	2005	Change
<b>All Other Insurance</b>			
Direct and Assumed			
Written Premiums	\$166,088	\$133,304	24.6 %
Net Written Premiums	\$ 86,821	\$ 77,040	12.7 %
Net Earned Premium	\$ 83,756	\$ 71,810	16.6 %
Agency Revenues	4,918	4,522	8.8 %
Service Fees	7	82	(91.5)%
Total Revenues	\$ 88,681	\$ 76,414	16.1 %
Income Before Taxes	\$ 26,751	\$ 19,903	

American Modern's excess and surplus lines and credit life products were the primary drivers of the increase in direct and assumed written premiums in 2006 compared to 2005. A large percentage of the Company's excess and surplus lines gross written premium is ceded to reinsurers. In addition, a large percentage of credit life direct and assumed written premium is ceded to an insurance affiliate of the producing agent. The growth in our credit life insurance line was assisted by the acquisition of Southern Pioneer Life Insurance Company in July of 2006. This acquisition contributed \$7.8 million of direct and assumed written premiums during the second half of 2006. The improvement in profitability in 2006 compared to 2005 is due primarily to the improved underwriting results related to the long haul truck, credit life and excess and surplus lines business combined with the profits generated from Southern Pioneer Life.

### Midland Consolidated

#### Investment Income and Realized Capital Gains

Although net investment income is allocated to segments and product lines, the investment portfolio is generally managed as a whole and therefore is more meaningfully discussed in total. Net investment income increased to \$42.2 million in 2006 from \$40.5 million in 2005. This increase was due primarily to an increase in investment yield combined with an increase in invested assets. The annualized pre-tax equivalent investment yield, on a cost basis, of the Company's fixed income portfolio was 5.9% in 2006 compared to 5.5% in 2005.

THE MIDLAND COMPANY AND SUBSIDIARIES

Realized investment gains and losses are comprised of three items: capital gains and losses from the sale of securities, derivatives features of certain convertible securities and other-than-temporary impairments. The following chart shows the gain or loss from these sources as well as their impact on diluted earnings per share (amounts in \$000's except per share amounts):

	December 31, 2006		
	Pre-Tax Gain (Loss)	After-Tax Gain (Loss)	Earnings Per Share
Capital Gains	\$7,404	\$4,892	\$0.26
Derivatives	1,041	677	0.03
Other-Than-Temporary Impairments	—	—	—
Net Realized Investment Gains	<b>\$8,445</b>	<b>\$5,569</b>	<b>\$0.29</b>

	December 31, 2005		
	Pre-Tax Gain (Loss)	After-Tax Gain (Loss)	Earnings Per Share
Capital Gains	\$5,870	\$3,815	\$0.20
Derivatives	392	255	0.01
Other-Than-Temporary Impairments	—	—	—
Net Realized Investment Gains	<b>\$6,262</b>	<b>\$4,070</b>	<b>\$0.21</b>

Derivatives relate to the equity conversion features attributable to the convertible preferred stocks and convertible debentures held by American Modern. The Company's investment portfolio does not currently include any other types of derivative investments.

*Insurance Losses and Loss Adjustment Expenses (LAE)*

Overall, American Modern's losses and loss adjustment expenses increased 7.3% in 2006 to \$307.5 million from \$286.7 million in 2005. The increase was due primarily to the related 7.0% increase in earned premiums in 2006 compared to 2005 combined with slight increases in loss ratios related to the manufactured housing, collateral protection and excess and surplus lines products. While the overall financial impact of catastrophes in 2006 improved compared to 2005, due to reinstatement premiums and other catastrophe related items in 2005, loss and loss adjustment expenses due to catastrophes remained relatively constant in 2006 at \$34.5 million compared to \$34.9 million in 2005.

*Insurance Commissions and Other Policy Acquisition Costs*

American Modern's commissions and other policy acquisition costs increased 5.6% in 2006 to \$209.7 million from \$198.6 million in 2005. This fluctuation is consistent with the increase in net earned premium. However, the majority of the fluctuation related to the increase in performance-based commission expense, with the up-front commissions increasing

only slightly. This change in the mix of commission expense is attributable to American Modern's "Pay for Performance" commission policy, with agents representing the Company, which reduces the up-front commission paid but rewards favorable underwriting and growth performance with a higher performance-based commission.

*Operating and Administrative Expenses*

The Company's operating and administrative expenses increased 13.3% to \$127.2 million in 2006 compared to \$112.3 million in 2005. This increase is due primarily to expenses related to an increase in employee salaries and benefits.

**Transportation**

M/G Transport, Midland's transportation subsidiary, contributed \$7.8 million of income, before taxes, in 2006 compared to \$4.9 million in 2005. In addition, M/G Transport's revenues increased to \$49.8 million in 2006 compared to \$42.2 million in 2005. The increases in transportation revenues and pre-tax income are due primarily to an improved freight rate environment that we expect to continue into 2007.

**RESULTS OF OPERATIONS  
YEAR ENDED DECEMBER 31, 2005 COMPARED  
TO YEAR ENDED DECEMBER 31, 2004**

**Insurance**

*Overview of Premium Volume*

The following chart shows American Modern's gross written premium, net written premium and net earned premium by business segment for the years ended December 31, 2005 and 2004 (in millions):

Business Segment	December 31, 2005		
	Gross Written Premium	Net Written Premium	Net Earned Premium
Residential Property	\$421.6	\$381.3	\$378.4
Recreational Casualty	100.5	98.2	103.3
Financial Institutions	79.1	70.8	78.4
All Other Insurance	133.3	77.1	71.8
Total	<b>\$734.5</b>	<b>\$627.4</b>	<b>\$631.9</b>

Business Segment	December 31, 2004		
	Gross Written Premium	Net Written Premium	Net Earned Premium
Residential Property	\$424.7	\$398.5	\$400.9
Recreational Casualty	111.3	109.6	119.2
Financial Institutions	101.5	99.2	86.8
All Other Insurance	117.0	77.6	70.7
Total	<b>\$754.5</b>	<b>\$684.9</b>	<b>\$677.6</b>

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

Gross written premium, net written premium and net earned premium decreased 2.7%, 8.4% and 6.7%, respectively, in 2005 compared to 2004. The more significant decrease in net written premium and net earned premium was due partially to a \$14.7 million increase in reinstatement premiums in 2005 compared to 2004. Reinstatement premiums, which are netted against net written premium and net earned premium but do not impact gross written premium, related to purchasing additional reinsurance in response to the severe hurricane season experienced in 2005. In addition to the increased reinstatement premiums, the Company experienced growth in several accounts where premium is ceded back to the producing agent.

#### Residential Property

The following chart is an overview of the results of operations of the company's residential property segment (in 000's).

	December 31,		
	2005	2004	Change
<b>Residential Property</b>			
Direct and Assumed			
Written Premiums	\$421,631	\$424,656	(0.7)%
Net Written Premiums	\$381,304	\$398,525	(4.3)%
Net Earned Premium	\$378,402	\$400,929	(5.6)%
Service Fees	5,651	5,615	0.6 %
Total Revenues	\$384,053	\$406,544	(5.5)%
Income Before Taxes	\$ 45,755	\$ 47,418	

The combined ratio for the residential property segment was 95.2% in 2005 compared to 94.3% in 2004. The results from this segment are driven primarily by the manufactured housing and site-built dwelling products. Although the manufactured housing industry continues to be depressed, American Modern's gross written premium related to this product remained relatively constant at \$331.5 million in 2005 compared to \$334.1 million in 2004. Site-built dwelling gross written premiums decreased 2.3% to \$86.4 million in 2005 compared to \$88.4 million in 2004.

The manufactured housing combined ratio, including catastrophe losses, decreased slightly to 94.4% in 2005 compared to 94.9% in 2004. Excluding catastrophe losses for both years, the combined ratio improved to 84.7% in 2005 from 86.0% in 2004. This improvement was due primarily to rate increases combined with improved underwriting. The site-built dwelling combined ratio increased to 98.3% in 2005 compared to 93.2% in 2004. Excluding catastrophe losses for both years, the combined ratio increased by 2 points to 91.9% in 2005 compared to 89.9% in 2004.

#### Recreational Casualty

The following chart is an overview of the results of operations of the company's recreational casualty segment (in 000's).

	December 31,		
	2005	2004	Change
<b>Recreational Casualty</b>			
Direct and Assumed			
Written Premiums	\$100,438	\$111,325	(9.8)%
Net Written Premiums	\$ 98,209	\$109,565	(10.4)%
Net Earned Premium	\$103,234	\$119,151	(13.4)%
Service Fees	2,373	2,281	4.0 %
Total Revenues	\$105,607	\$121,432	(13.0)%
Income Before Taxes	\$ 12,693	\$ 4,987	

Gross written premiums for our recreational casualty products decreased due primarily to the planned decrease in motorcycle premiums as American Modern took the necessary corrective underwriting actions and rate increases to position the motorcycle product for profitability. In addition, we have added expertise to our staff and have refined our product offering to better match the needs of our target market. As a result of these actions, the combined ratio for the motorcycle product improved to 91.1% in 2005 compared to 102.3% in 2004. As American Modern has now properly positioned the motorcycle product, we intend to implement strategies to profitably increase premiums for the product in the upcoming years.

#### Financial Institutions

The following chart is an overview of the results of operations of the company's financial institutions insurance segment (in 000's).

	December 31,		
	2005	2004	Change
<b>Financial Institutions</b>			
Direct and Assumed			
Written Premiums	\$ 79,108	\$101,510	(22.1)%
Net Written Premiums	\$ 70,817	\$ 99,230	(28.6)%
Net Earned Premium	\$ 78,424	\$ 86,803	(9.7)%
Total Revenues	\$ 78,424	\$ 86,803	(9.7)%
Income Before Taxes	\$ 9,471	\$ 6,991	

The decrease in gross written premiums for our financial institutions insurance products was driven by the collateral protection and mortgage fire products which decreased \$11.0 million and \$7.9 million, respectively, compared to the prior year. The decrease in collateral protection gross written

THE MIDLAND COMPANY AND SUBSIDIARIES

premiums in 2005 compared to 2004 was due to the assumption of a \$17.6 million book of business during the second quarter of 2004 which included a one-time assumption of unearned premium totaling \$13.6 million. The decrease in mortgage fire gross written premiums resulted primarily from the sale of a mortgage portfolio in 2005 which was serviced by one of our agents within this line.

Profits increased for our financial institutions insurance products as this segment was impacted by a \$3.4 million loss related to the run-off of a cancelled product line in 2004. No such run-off losses were incurred in 2005.

*All Other Insurance*

The following chart is an overview of the results of operations of the company's all other insurance segment (in 000's).

	December 31,		
	2005	2004	Change
<b>All Other Insurance</b>			
Direct and Assumed			
Written Premiums	\$133,304	\$117,005	13.9 %
Net Written Premiums	\$ 77,040	\$ 77,584	(0.7)%
Net Earned Premium	\$ 71,810	\$ 70,710	1.6 %
Agency Revenues	4,522	5,562	(18.7)%
Service Fees	82	133	(38.3)%
Total Revenues	\$ 76,414	\$ 76,405	0.0 %
Income Before Taxes	\$ 19,903	\$ 12,396	

American Modern's excess and surplus lines and credit life products were the primary drivers of the increase in gross written premiums in 2005 compared to 2004. A large percentage of the Company's excess and surplus lines gross written premium is ceded to reinsurers. In addition, a large percentage of credit life gross written premium is ceded to an insurance affiliate of the producing agent. The improvement in profitability in 2005 compared to 2004 is due primarily to the improved underwriting results related to our excess and surplus lines business and our park and dealer business.

**Midland Consolidated**

*Investment Income and Realized Capital Gains*

Although net investment income is allocated to segments and product lines, the investment portfolio is generally managed as a whole and therefore is more meaningfully discussed in total. Net investment income increased to \$40.5 million in 2005 from \$37.2 million in 2004. This increase was due primarily to an increase in investment yield. The annualized pre-tax equivalent investment yield, on a cost basis, of the Company's fixed income portfolio was 5.5% in 2005 compared to 5.2% in 2004.

Realized investment gains and losses are comprised of three items: capital gains and losses from the sale of securities, derivatives features of certain convertible securities and other-than-temporary impairments. The following chart shows the gain or loss from these sources as well as their impact on diluted earnings per share (amounts in \$000's except per share amounts):

	December 31, 2005		
	Pre-Tax Gain (Loss)	After-Tax Gain (Loss)	Earnings Per Share
Capital Gains	\$5,870	\$3,815	\$0.20
Derivatives	392	255	0.01
Other-Than-Temporary Impairments	—	—	—
Net Realized Investment Gains	\$6,262	\$4,070	\$0.21

	December 31, 2004		
	Pre-Tax Gain (Loss)	After-Tax Gain (Loss)	Earnings Per Share
Capital Gains	\$9,169	\$5,960	\$0.31
Derivatives	764	497	0.03
Other-Than-Temporary Impairments	—	—	—
Net Realized Investment Gains	\$9,933	\$6,457	\$0.34

Derivatives relate to the equity conversion features attributable to the convertible preferred stocks and convertible debentures held by American Modern. The Company's investment portfolio does not currently include any other types of derivative investments.

*Insurance Losses and Loss Adjustment Expenses (LAE)*

Overall, American Modern's losses and loss adjustment expenses decreased 17.8% in 2005 to \$286.7 million from \$348.6 million in 2004. As mentioned in the segment discussions above, the decrease was due primarily to improved underwriting results for the motorcycle, excess and surplus lines, and park and dealer products combined with decreased earned premiums in 2005 compared to 2004. While the overall financial impact of catastrophes in 2005 was worse than 2004, due to reinstatement premiums and other catastrophe related items, loss and loss adjustment expenses due to catastrophes actually decreased in 2005 to \$34.9 million compared to \$42.7 million in 2004.

During 2005 and 2004 the company experienced favorable loss development, while it experienced unfavorable loss development in 2003. This was attributable to several factors. The company exited a commercial liability product line in 2001 related to manufactured housing park operators and dealers. Original loss reserve estimates in 2001 and 2002 related to this line were not adequate. Loss reserve estimates were increased in 2003 to

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

account for this deficiency. Subsequent settlement of these reserves has been for amounts below the revised loss reserves, resulting in a redundancy in 2004 and 2005. Another factor that contributed to the favorable development was an overestimate of the reserves related to the motorcycle line of business, the excess and surplus lines business and the liability component of our other personal lines products. The liability components associated with these lines are inherently less predictable than the company's traditional property coverages. The company entered the motorcycle line in 2000 and the excess and surplus lines in 2002. The excess and surplus line has continued to grow at a rapid pace while the motorcycle line contracted in 2004 and 2005.

### Insurance Commissions and Other Policy Acquisition Costs

American Modern's commissions and other policy acquisition costs decreased 1.3% in 2005 to \$198.6 million from \$201.2 million in 2004. This decrease is attributable to the decrease in net earned premium. However, the decrease was partially offset by an increase in performance-based commission expense as a result of the improved underwriting results achieved in 2005 compared to 2004. The fluctuations in performance-based commission expense are attributable, in part, to American Modern's "Pay for Performance" commission policy with agents representing the Company which reduces the up-front commission paid but rewards favorable underwriting and growth performance with a higher performance-based commission.

### Operating and Administrative Expenses

The Company's operating and administrative expenses increased 3.5% to \$112.3 million in 2005 compared to \$108.5 million in 2004. This increase is due primarily to expenses related to modernLINK®, our proprietary information systems and web enablement initiative, and an increase in employee salaries and benefits. In addition, the Company adopted Statement of Financial Accounting Standards ("SFAS") 123(R) in 2005 which resulted in the recognition of \$1.9 million in stock option expense.

### Transportation

M/G Transport, Midland's transportation subsidiary, contributed \$4.9 million of income, before taxes, in 2005 compared to \$1.7 million in 2004. The increased profitability was due partially to significantly improved freight rates during 2005. In addition, M/G Transport focused its resources on shorter, more profitable moves in 2005. This strategy considerably improved M/G Transport's profitability, but hampered its top line revenues. In fact, M/G Transport's revenues decreased slightly to \$42.2 million in 2005 compared to \$45.4 million in 2004.

## LIQUIDITY, CAPITAL RESOURCES AND CHANGES IN FINANCIAL CONDITION

### Consolidated Operations

#### Contractual Obligations

We have certain obligations and commitments to make future payments under contracts. As of December 31, 2006, the aggregate obligations on a consolidated basis were as follows (amounts in 000's):

	Payments Due By Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
Long-term debt and interest	\$108,908	\$ 21,422	\$ 39,584	\$40,282	\$ 7,620
Other notes payable	17,937	17,937	—	—	—
Annual commitments under non-cancelable leases	33,284	2,886	4,982	5,069	20,347
Purchase obligations	26,524	23,905	2,265	354	—
Other obligations	268	268	—	—	—
Insurance policy loss reserves	221,639	122,788	64,940	19,948	13,963
<b>Total</b>	<b>\$408,560</b>	<b>\$189,206</b>	<b>\$111,771</b>	<b>\$65,653</b>	<b>\$41,930</b>

The table above excludes contracts and agreements that relate to maintenance and service agreements which, individually and in the aggregate, are not material to the Company's operations or financial condition and are terminable by the Company with minimal advance notice and little or no cost to the Company.

The interest rates related to portions of the long-term debt in the above table are variable in nature and the interest payments included in the table have been calculated using the rates in effect at December 31, 2006.

The insurance policy loss reserve payment projections in the above table are based on actuarial assumptions. The actual payments will vary, in both amount and time periods, from the estimated amounts represented in this table. See further discussion regarding insurance policy loss reserves under the Critical Accounting Policies section.

Also included in the above table are four fifteen-year operating lease arrangements relating to the lease of 80 barges used in the transportation operations. The barges can be purchased near the end of the fifteen-year terms at predetermined prices or, at the end of each lease period, the company can either return the barges or purchase the equipment at fair market value. For all of the aforementioned operating leases, the 15-year lease periods were more attractive at the time than the traditional 5-year financing term for conventional long-term debt. As of December 31, 2006 future lease payments required under these operating lease arrangements are (000's): 2007 – \$2,444; 2008 through 2009 – \$4,910; 2010 through 2011 – \$5,069; after 5 years – \$20,347. M/G Transport's operating cash flow is currently sufficient to pay the financial obligations under this agreement. Also included under purchase obligations in the above table is \$10.7 million related to a contract to acquire an additional 25 jumbo open barges in 2007.

The Company is in the process of significantly expanding its headquarters. The expansion, which is scheduled for completion in September 2007, will add approximately 205,000 square feet of new office space and will expand an existing training center by approximately 20,000 square feet. The new facility, which is expected to cost approximately \$29 million (\$17.4 has been capitalized through December 31, 2006 with the remaining \$11.6 million included in the purchase obligations line in the above table), will be financed through operating cash flows and short term debt borrowings during the construction phase. The Company is considering various financing options for the building once construction is completed.

#### *Off Balance Sheet Arrangements*

We do not utilize any special-purpose financing vehicles or have any undisclosed off balance sheet arrangements. Similarly, the Company holds no fair-value contracts for which a lack of marketplace quotations would necessitate the use of fair value techniques.

#### **Other Items**

No shares were repurchased in the open market under the Company's share repurchase program during 2006. On April 27, 2006, the Company's Board of Directors approved a two-year extension to the share repurchase program that will run through the date of the Board's second quarterly meeting in 2008. In addition, 500,000 additional shares were authorized for repurchase bringing the total to 1,086,000 shares that remain authorized for repurchase under terms of this program. The resolution does not require the repurchase of shares, but rather gives management discretion to make purchases based on market conditions and the Company's capital requirements.

The share repurchase program pertains exclusively to shares to be purchased on the open market. This program specifically excludes shares repurchased in connection with stock incentive plans. The Company may periodically repurchase stock awarded to associates in connection with stock incentive programs. Such repurchase transactions essentially accommodate associates funding of the exercise price and any tax liabilities arising from the exercise or receipt of equity based incentive awards. During 2006, the Company repurchased 30,288 shares for approximately \$2.1 million in connection with associate stock programs.

We paid dividends to our shareholders of \$4.6 million during 2006, \$4.2 million in 2005 and \$3.7 million in 2004. In 2007, we expect to pay approximately \$7.7 million in dividends to our shareholders due to increasing our annual dividend to \$0.40 per share in 2007 compared to \$0.245 per share in 2006.

We expect that our existing cash and other liquid investments, coupled with future operating cash flows and our short-term borrowing capacity, will meet our future operating cash requirements.

#### **Holding Company Operations**

Midland and American Modern are holding companies which rely primarily on dividends and management fees from subsidiaries to assist in servicing debt, paying operating expenses and paying dividends to the respective shareholders. The payment of dividends to these holding companies from

American Modern's insurance subsidiaries is restricted by state regulatory agencies. Such restrictions, however, have not had, and are not expected to have, a significant impact on our, or American Modern's, liquidity or our and American Modern's ability to meet our respective long or short-term operating, financing or capital obligations.

Midland has a commercial paper program under which qualified purchasers may invest in the short-term unsecured notes of Midland. As of December 31, 2006, we had \$7.9 million of commercial paper debt outstanding, \$6.6 million of which represented notes held either directly or indirectly by our executive officers and directors. The effective annual yield paid to all participants in this program was 5.4% as of December 31, 2006, a rate that is considered to be competitive with the market rates offered for similar instruments. As of December 31, 2006, Midland also had \$83.0 million of conventional short-term credit lines available at costs not exceeding prime borrowing rates, of which \$10.0 million was outstanding. These lines of credit contain minimal covenants and are typically drawn and repaid over periods ranging from two weeks to three months. We also have a mortgage obligation related to the financing of our corporate headquarters building. As of December 31, 2006, the outstanding balance of this mortgage was \$13.9 million. This mortgage obligation includes normal and customary debt covenants for instruments of this type. Monthly interest payments are required until maturity in December 2007. The effective interest rate on this obligation is based on LIBOR plus 1% and was 6.31% at December 31, 2006.

On October 21, 2003 Midland filed a shelf registration statement with the Securities and Exchange Commission. This registration statement will allow the Company to offer from time to time up to \$150.0 million in various types of securities, including debt, preferred stock and common stock. On February 5, 2004, Midland sold 1,150,000 shares of its common stock authorized by this shelf registration. The net proceeds received of \$25.1 million were used to increase the capital base of its insurance subsidiaries to provide for future growth and for other general corporate purposes.

During the second quarter of 2004, Midland, through wholly owned trusts, issued \$24.0 million of junior subordinated debt securities (\$12.0 million on April 29 and \$12.0 million on May 26). These transactions were part of the Company's participation in pooled trust preferred offerings. The proceeds from these transactions are available to fund future growth and for general corporate purposes. The debt issues have 30-year terms and are callable any time after five years at the Company's option. The interest related to the debt is variable in nature. The debt contains certain provisions which are typical and customary for this type of security.

#### **Investment in Marketable Securities**

The market value of Midland's consolidated investment portfolio (comprised primarily of the investment holdings of American Modern) increased 8.9% to \$1,031.4 million at December 31, 2006 from \$947.1 million at December 31, 2005. This increase was due, in part, to the positive cash flow from operations combined with the reinvestment of interest and dividends received throughout 2006. The increase was also due to

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

the \$26.0 million increase in unrealized appreciation in the market value of the securities held at December 31, 2006 compared to year end 2005. The increase in the unrealized appreciation was due to a \$25.6 million increase in unrealized appreciation related to the equity portfolio combined with a \$0.4 million increase in unrealized appreciation pertaining to the fixed income portfolio. Midland's largest equity holding, 2.5 million shares of U.S. Bancorp, increased to \$88.8 million as of December 31, 2006 from \$73.5 million as of December 31, 2005.

Securities with unrealized gains and losses by category (equity and debt) and by time frame are summarized in the chart below (amounts in 000's):

Unrealized Gain (Loss) as of December 31, 2006			
	Unrealized Gain (Loss)	Fair Value	# of Positions
<b>Fixed Income Securities</b>			
Total held in a gain position	\$ 12,154	\$ 530,221	820
Held in a loss position			
for less than 3 months	(359)	73,574	106
Held in a loss position			
for more than 3 months and less than 9 months	(266)	12,101	21
Held in a loss position			
for more than 9 months and less than 18 months	(1,678)	134,515	155
Held in a loss position			
for more than 18 months	(1,167)	41,310	73
Fixed income total	<u>\$ 8,684</u>	<u>\$ 791,721</u>	<u>1,175</u>
<b>Equity Securities</b>			
Total held in a gain position	\$112,690	\$ 217,274	167
Held in a loss position			
for less than 3 months	(163)	5,482	8
Held in a loss position			
for more than 3 months and less than 9 months	(86)	909	6
Held in a loss position			
for more than 9 months and less than 18 months	(316)	3,476	7
Held in a loss position			
for more than 18 months	(89)	1,388	2
Equity total	<u>\$112,036</u>	<u>\$ 228,529</u>	<u>190</u>
Total per above	\$120,720	\$1,020,250	1,365
Accrued interest and dividends	—	11,127	
Total per balance sheet	<u>\$120,720</u>	<u>\$1,031,377</u>	

Based on the above valuations and the application of our other-than-temporary impairment policy criteria, which is more fully discussed in the Critical Accounting Policies section below, we believe the declines in fair value are temporary at December 31, 2006. However, the facts and circumstances related to these securities may change in future periods, which could result in "other-than-temporary" impairment in future periods.

The average duration of the Company's debt security investment portfolio as of December 31, 2006 was 5.0 years which management believes provides adequate asset/liability matching.

### Midland Consolidated

American Modern generates cash inflows primarily from insurance premium, investment income, proceeds from the sale of marketable securities and maturities of debt security investments. The principal cash outflows for the insurance operations relate to the payment of claims, commissions, premium taxes, operating expenses, capital expenditures, income taxes, interest on debt, dividends and inter-company borrowings and the purchase of marketable securities. In each of the periods presented, funds generated from the insurance operating activities were used primarily to purchase investment grade marketable securities, accounting for the majority of the cash used in investing activities.

The amounts expended for the development costs capitalized in connection with the development of modernLINK®, our proprietary information systems and web enablement initiative, amounted to \$10.0 million in 2006 and a total of \$40.3 million from inception in 2000 through December 31, 2006. The initiative is being designed, developed and implemented in periodic phases to ensure its cost effectiveness and functionality. This project may involve future cash expenditures in the range of \$40 million to \$45 million over the next four years, with additional spending thereafter to expand system compatibility and functionality. A portion of such expenditures will be capitalized and amortized over the useful life. However, actual costs may be more or less than what we estimate. The cost of the development and implementation is expected to be funded out of operating cash flow. Significant changes to the technology interface between American Modern and its distribution channel participants and policyholders, while unlikely, could significantly disrupt or alter its distribution channel relationships. If the new information systems are ultimately deemed ineffective, it could result in an impairment charge to our capitalized costs. The unamortized balance of modernLINK®'s software development costs was \$28.3 million at December 31, 2006.

American Modern has a \$72.0 million long-term credit facility available on a revolving basis at various rates. As of December 31, 2006, there was \$36.0 million outstanding under these facilities.

Accounts receivable is primarily comprised of premium due from both policyholders and agents. In the case of receivables due directly from policyholders, policies are cancelable in the event of non-payment and thus offer minimal credit exposure. Approximately 63% of American Modern's accounts receivables relate to premium due directly from policyholders as of December 31, 2006. In the case of receivables due from agents, American Modern has extended payment terms that are customary and normal in the insurance industry. Management monitors its credit exposure with its agents and related concentrations on a regular basis. However, as collectibility of such receivables is dependent upon the financial stability of the agent, American Modern cannot assure collections in full. Where management believes appropriate, American Modern has provided a reserve for

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such exposures. Accounts receivable increased \$11.1 million to \$148.2 million at December 31, 2006 compared to \$137.1 million at year end 2005. The increase is due to the corresponding increase in written premiums in 2006 compared to 2005.

Reinsurance recoverables and prepaid reinsurance premiums consisted of the following amounts (amounts in 000's):

	As of December 31,	
	2006	2005
Prepaid reinsurance premiums	\$ 67,063	\$ 49,549
Reinsurance recoverable—unpaid losses	54,550	62,241
Reinsurance recoverable—paid losses	6,893	20,947
Total	<u>\$128,506</u>	<u>\$132,737</u>

The decrease in reinsurance recoverables of \$21.7 million at December 31, 2006 compared to 2005 is attributable primarily to the settlement of loss recoverables in 2006 related to the 2005 hurricanes. The increase in prepaid reinsurance premiums is due to the related increase in ceded written premiums during 2006.

The increase in property, plant and equipment of \$29.0 million at December 31, 2006 compared to 2005 is due to the costs incurred to date related to the expansion of the Company's headquarters, the continuing investment in modernLINK®, and M/G Transport's purchase of 15 additional barges.

The \$50.3 million increase in unearned insurance premiums at December 31, 2006 compared to year end 2005 is related to the \$97.3 million increase in the Company's direct and assumed written premiums.

The decrease of \$33.0 million in insurance loss reserves was due primarily to the settlement of losses in 2006 related to hurricanes Katrina, Rita and Wilma. The following table provides additional detail surrounding the Company's insurance policy loss reserves at December 31, 2006 and 2005 (amounts in 000's):

	December 31,	
	2006	2005
Gross case base loss reserves:		
Residential property	\$ 43,736	\$ 57,845
Recreational casualty	23,160	34,742
Financial institutions	11,004	10,289
All other insurance	71,896	58,516
Gross loss reserves incurred but not reported	51,107	54,896
Outstanding checks and drafts	20,736	38,372
Total insurance loss reserves	<u>\$221,639</u>	<u>\$254,660</u>

Cash flow from the insurance operations is expected to remain sufficiently positive to meet American Modern's future operating requirements and to provide for reasonable dividends to Midland.

## Transportation

M/G Transport generates its cash inflows primarily from affreightment revenue. Its primary outflows of cash relate to the payment of barge charter costs, debt service obligations, operating expenses, income taxes, dividends to Midland and the acquisition of capital equipment. Like the insurance operations, cash flow from the transportation subsidiaries is expected to remain sufficiently positive to meet future operating requirements.

M/G Transport entered into a fifteen-year lease in 1999 for transportation equipment. Aggregate rental payments under this operating lease over the next eight years will approximate \$4.7 million. M/G Transport also entered into three fifteen-year operating leases related to the leasing of an additional 60 barges during the fourth quarter of 2006. Aggregate rental payments under these operating leases over the next fifteen years will approximate \$28.1 million. In addition to the 2006 operating leases, M/G Transport purchased fifteen barges in the fourth quarter of 2006 for approximately \$6.3 million.

In 2003, M/G Transport adopted the provisions of FASB Interpretation No. 46 ("FIN" 46), "Consolidation of Variable Interest Entities", and capitalized an operating lease related to certain transportation equipment. The recorded asset value was subsequently determined to be in excess of its fair market value and impairment charges of \$0.8 million (pre-tax) and \$0.5 million (pre-tax) were recorded in 2004 and 2003, respectively. Later in 2004, the Company sold the transportation equipment for \$1.7 million and recognized a pre-tax gain of \$0.2 million. The Company used the proceeds from this sale to eliminate the debt related to the equipment.

As of December 31, 2006, the transportation subsidiaries have \$16.6 million of collateralized equipment obligations outstanding.

## OTHER MATTERS

### Comprehensive Income

The differences between our net income and comprehensive income are changes in unrealized gains on marketable securities, changes in the fair value of the interest rate swap agreement and additional minimum liability requirements related to our defined benefit pension plans. For the years ended December 31, 2006, 2005 and 2004, such changes increased or (decreased), net of related income tax effects, by the following amounts (amounts in 000's):

	2006	2005	2004
Changes in:			
Net unrealized capital gains	\$16,899	\$(13,877)	\$ 966
Fair value of interest rate swap hedge	—	280	651
Additional minimum pension liability	1,216	(1,567)	\$(2,045)
Total	<u>\$18,115</u>	<u>\$(15,164)</u>	<u>\$ (428)</u>

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

Net unrealized investment gains in equity securities (net of income tax effects) increased \$16.6 million in 2006, decreased \$2.9 million in 2005 and increased \$2.7 million in 2004. For fixed income securities, net unrealized gains increased \$0.3 million in 2006, decreased \$11.0 million in 2005 and decreased \$1.7 million in 2004.

Changes in net unrealized gains on marketable securities result from both market conditions and realized gains recognized in a reporting period. The interest rate swap agreement expired on December 1, 2005. While the interest rate swap agreement was in place, its after-tax fair value varied according to the current interest rate environment relative to the fixed rate of the swap agreement. Changes in the additional minimum pension liability are actuarially determined based on the funded status of the plans and current actuarial assumptions.

### Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. We regularly evaluate our critical accounting policies, assumptions and estimates, including those related to insurance revenue and expense recognition, loss reserves and reinsurance. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances. This process forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies require significant judgments and estimates in the preparation of our consolidated financial statements.

#### *Insurance Revenue and Expense Recognition*

Premiums for physical damage and other property and casualty related coverages, net of premium ceded to reinsurers, are recognized as income on a pro-rata basis over the lives of the policies. Credit accident and health and credit life premiums are recognized as income over the lives of the policies in proportion to the amount of insurance protection provided. American Modern generally does not consider anticipated investment income in determining premium deficiencies (if any) on short-term contracts. Policy acquisition costs, primarily commission expenses and premium taxes, are capitalized and expensed over the terms of the related policies on the same basis as the related premiums are earned. Selling and administrative expenses that are not primarily related to premiums written are expensed as incurred.

#### *Transportation Revenue Recognition*

Revenues for river transportation activities are recognized when earned. If freight services are in process at the end of a reporting period, an allocation of revenue between reporting periods is made based on relative transit time in each reporting period with expenses recognized as incurred.

#### *Insurance Policy Loss Reserves*

Our loss reserves are comprised of two main components, case base loss reserves and incurred-but-not-reported loss reserves. Loss reserves include both loss and loss adjustment expense and are reported net of salvage and subrogation.

Case base loss reserves are estimated liabilities set for specifically identified outstanding losses incurred to date to be paid in the future. Case base loss reserves are based on the specific facts and circumstances of reported claims, but still require a significant amount of judgment. Case base reserves are established after notice of loss is received. The initial amount of the case base reserve is based on the policy coverages and limits, loss description, exposure information (i.e., insured product and insured value), cause of loss and historical loss cost information. The claim reserves are subsequently adjusted by claims personnel as more information becomes available in the claim adjustment process, through such procedures as a physical inspection of the loss. In many of our property lines of business, our adjusters utilize specialized claim estimatic software to assist in the claim estimation process. The claim estimatic software utilizes historical information and considers factors such as the region to assist in the estimated value of such items as materials, labor and depreciation, as applicable. Case base loss reserves are subsequently revised based on additional information until the claim is ultimately paid. The case base claims from our property lines of business tend to be reported and settled rather quickly. We estimate that property claims are reported to us, on average, approximately 30 days after the loss incurred date and approximately 90 percent are settled within 30 days from when they are reported to us. Losses for our liability lines of business are generally reported to us much longer after the loss incurred date as compared to our property lines of business. The majority of our liability claims are settled within 90 days of being reported to us. However, it is not unusual to have liability claims that are not reported to us for as much as several years after the actual loss has occurred and for these claims to take an extended period of time to actually settle. This is particularly true in our exited commercial park and dealer liability business and to a lesser extent, in our excess and surplus lines. We estimate that approximately 55 percent of our case base loss reserves relate to property coverages and 45 percent relate to liability coverages. The Company's philosophy is to adequately reserve our case base claims in a consistent manner.

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The objective of the incurred-but-not-reported loss (IBNR) reserve is to establish a reserve for claims that have been incurred by our policyholders but not yet been reported to us and to contemplate any deficiency or redundancy in case base loss reserves as of a particular reporting date. In determining the recorded amount for the incurred-but-not-reported loss reserves for a reporting period management considers the following factors to determine if an adjustment to the incurred-but-not-reported loss reserve is necessary:

- Trends or patterns in claim experience. We regularly review the level of loss reserves against actual loss development. This retrospective review is the primary criteria used in refining the levels of loss reserves recorded in the financial statements.
- Trends or patterns noted in management's regular discussions with internal and external consulting actuaries. We meet with our external actuary on a quarterly basis and have ongoing discussions as necessary. We also consider the summarized statistical results from previous meetings with our external actuary in refining our IBNR reserves.
- Management and the actuaries also meet periodically with Claims and Product personnel to review ongoing business trends, claim frequency and severity statistics and other relevant developmental trends.
- We consider changes in our business, product mix, current events and any changes in case base claims reserving philosophies.

Based on the factors considered above, management adjusts the recorded balance of loss reserves, as necessary, to reflect their best estimate, which is recorded in the financial statements. In considering whether any adjustments are necessary to the incurred-but-not-reported loss reserve, we contemplate our loss reserves in total.

Management validates the recorded reserve amount by engaging an accredited consulting actuarial specialist. Following the end of each quarterly reporting period, but prior to the issuance of the financial statements, the consulting actuary develops an "acceptable actuarial range" for loss reserves. The external actuary utilizes various statistical models and analyses, in accordance with generally accepted actuarial standards, to determine this acceptable actuarial range. Management compares the recorded amount of loss reserves to the actuarial range. This range typically involves a fluctuation of approximately 10 percent. The loss reserve recorded balance is affirmed if it is within the acceptable actuarial range. If the recorded balance is outside of the actuarial range, management would make the necessary adjustment to the recorded balance. Historically, the recorded balance has been within the acceptable actuarial range, therefore no such adjustment has been necessary. We have consistently applied this approach to estimating loss reserves.

A summary of our loss reserves at December 31, 2006 and 2005 is included below:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Property and casualty net case base reserves	<b>\$103,782</b>	\$103,915
Property and casualty net incurred but not reported reserves	<b>35,204</b>	44,151
Property and casualty net loss reserves	<b>\$138,986</b>	\$148,066
Property and casualty net loss reserves	<b>\$138,986</b>	\$148,066
Property and casualty reinsurance recoverables	<b>42,802</b>	53,844
Property and casualty gross loss reserves	<b>181,788</b>	201,910
Life and other gross loss reserves	<b>19,115</b>	14,378
Outstanding checks and drafts	<b>20,736</b>	38,372
Consolidated gross loss reserves	<b>\$221,639</b>	\$254,660

As noted in the table above, case base loss reserves represent the largest component of our loss reserves at approximately 75 percent of our net property and casualty loss reserves. Primarily composed of case base loss reserves, our total loss reserves are relatively short-tailed in nature and less as a percentage of statutory surplus than the property and casualty industry average. In total, our net property and casualty loss reserves represented 32% and 40% of the statutory property and casualty surplus at December 31, 2006 and 2005, respectively. In comparison, statutory loss reserves approximate 120% of statutory surplus for the property and casualty industry. Case base loss reserves tend to be more mechanical in nature and are based on specific facts and circumstances related to reported claims as compared to IBNR loss reserves, which have a higher degree of estimation and uncertainty.

In the loss reserve estimation process, accuracy of the recorded amounts is the primary objective. However, due to the uncertainty inherent in the process, we approach our loss reserves with an implicit degree of caution for adverse deviation although we do not specifically utilize an implicit or explicit provision for uncertainty or adjust any one specific assumption.

Each year, the credentialed consulting actuary computes an acceptable range for property and casualty reserves, which affirms management's recorded balance if the recorded amount is within the range. At December 31, 2006, our estimate of property and casualty net loss reserves totaled \$139.0 million, which was affirmed by the company's consulting actuary range of \$125.9 million to \$143.7 million. However, in light of the significant assumptions and judgments used to estimate loss reserves, there can be no assurance that the actual losses ultimately experienced will fall within the consulting actuary's range. The

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

range is based on a "reasonable best case" and "reasonable worst case" with varying development patterns across our lines of business. However, the development of the December 31, 2006 loss reserves could be impacted by the following:

- At December 31, 2006, the recorded net property and casualty loss reserves were in the upper half of the acceptable actuarial range.
- We have considered the acceptable actuarial range. The range is based on a "reasonable best case" and "reasonable worst case" with varying development patterns across our lines of business.
- We have considered that our historical loss development factors are more fully encompassing favorable development patterns that we have experienced over the last few years.

We have consistently applied our approach to loss reserves. Our estimates for loss reserves utilize historical loss development patterns. As new patterns emerge, they are reflected in our assumptions. Due to the significant amount of judgment and estimation that is required to estimate loss reserves, the actual loss development is likely to be different than the amounts recorded. For example, during the last 10 years we have experienced both favorable and unfavorable development in individual calendar years. Looking back at our net property and casualty loss reserves over the last ten years, we have experienced eight years where redundancy has developed and two years where a deficiency developed. The table below outlines the cumulative (deficiency)/redundancy for the net property and casualty loss reserves since 1996, based on re-estimated amounts at December 31, 2006.

Year	P&C Net Loss Reserves Original Balance	Cumulative (Deficiency) / Redundancy Based on 12/31/2006 Re-estimation	(Deficiency) / Redundancy as Percent of Original Reserves
1996	\$ 64,784	\$ (2,723)	-4.2%
1997	81,901	4,407	5.4%
1998	88,267	10,249	11.6%
1999	89,325	3,054	3.4%
2000	95,022	695	0.7%
2001	102,858	3,208	3.1%
2002	115,584	(2,354)	-2.0%
2003	149,478	32,876	22.0%
2004	166,302	39,108	23.5%
2005	148,066	10,010	6.8%
2006	138,986	NA	
<b>10-Year Average</b>			<b>7.0%</b>

With the benefit of hindsight, including one year of actual development patterns observed during 2006, our 2005 loss reserves were subsequently re-estimated to be \$138.1 million. This produced a net cumulative redundancy, after one year of

development, of \$10.0 million. Although the 2005 loss reserves developed favorably in 2006, the redundancy was lower than what was experienced over the last few years. The lower redundancy related to the 2005 loss reserves was due primarily to adverse development in 2006 related to assessments associated with hurricane Katrina, our personal liability lines and our excess and surplus lines of business. The Company continued to see favorable development related to its motorcycle product.

In 2004 and 2005, we experienced more favorable development patterns than we have historically experienced in several of our lines. These lines included the motorcycle and excess and surplus lines as well as personal liability coverages associated with some of our products. The development patterns were more favorable than our historical trends and baseline industry information would have indicated at that time. In addition, during 2004 and 2005, we also experienced a decrease in the non-catastrophe related frequency in our residential property products, such as manufactured housing and site-built dwelling. The actual frequency that we have experienced during these years is below our historical averages, which are included as part of our baseline assumptions. However, we believe that this level of frequency is a short term variation and may not be sustainable over a long period of time.

We believe the recent favorable IBNR development was caused, in part, by lower non-catastrophe related frequency patterns than we have experienced historically, a higher level of case base redundancies, and favorable loss development in our newer lines of business. The case base redundancy was due in part to our response to the loss reserve deficiencies for the December 31, 2002 loss reserves that were ultimately discovered during 2003. In response to deficient development of reserves, management strengthened the company's loss reserves to reflect these changing development trends arriving at a best estimate of how these losses would ultimately settle. The higher levels of loss reserves, and their potential redundancy, were not fully contemplated in the incurred-but-not-reported loss reserves, because our experience had not been validated over an appropriate period of time.

Although we have experienced better than expected claim activity in 2004 and 2005, we believe that several of our lines of business (including excess and surplus lines, personal liability and park and dealer liability) may still experience additional development in the future because of the liability components that are underwritten. Therefore, the 2004 redundancy reflected after one year of development may ultimately be more or less in future years. The potential for future development is evidenced by the fact that we experienced some adverse development related to losses that occurred in 2004 during 2006 in our personal liability and excess and surplus lines business.

Consequently, despite the recent experience, we have not changed our reserving approach or assumptions and we do not anticipate changing our reserving methodology until we believe that development trends have become sustainable. In determining our estimate of loss reserves, we apply caution to short term variations from historical patterns. We believe that short term variations must be viewed with skepticism and history shows that they do not produce data that is actionable until validated for an appropriate period of time. The evaluation of short term variations is highly subjective and often depends on

specific facts and circumstances. Generally, to determine if a short term variation requires action, we analyze the specific facts and circumstances of the trend and evaluate data to determine whether the trend is sustainable. We believe that this approach avoids inappropriate volatility to the income statement. In order to determine whether variations from our historical patterns represent ongoing trends, management meets quarterly with Claims and Product personnel to review business developments, claim frequency and severity statistics and other relevant developmental trends. Additionally, management from various areas of the business (including product, claims and underwriting personnel) meet monthly to discuss trends relating to the products. Management also considers changes in our business, product mix and case base claims reserving philosophies when deciding whether the loss development patterns are sustainable.

The loss reserves from the following lines of business tend to be more difficult to predict as compared to the larger property portion of our business.

- Motorcycle is a less mature product line that we began writing in 2001. We, therefore, did not have as much historical data related to this product. In addition, as we began writing this business, we experienced a very high loss ratio, relative to our, and industry standards. This was largely due to the initial underwriting criteria and our limited claim handling experience. Since 2001, we have made significant underwriting changes to this product and have also developed claim expertise and experience in settling claims related to this line thus causing more favorable development in recent years.
- Personal liability and park and dealer liability tend to be more volatile due to the liability component of these risks, which has a higher degree of complexity and a longer development period when compared to the larger property portion of our business. We exited the park and dealer liability lines in 2001 and we had experienced several years of volatility and inadequate reserves related to this line at December 31, 2003. Subsequently, we have experienced claims being settled for less than the amount reserved.
- The excess and surplus lines are new lines of business to the Company. We began writing excess and surplus in 2002 and we therefore do not have a large amount of historical development data. Additionally, the excess and surplus lines contain a higher degree of liability risks and the reserving methodology is more dependent on longer term development patterns.

Essentially, in each of these lines we experienced more favorable development in 2005 than our historical development and baseline industry data would have indicated. The favorable development in 2005 was the result of a combination of redundant case base reserves, where claims were settled for less than the reserved amount, and lower non-catastrophe related frequency patterns than we have historically experienced. We estimate that redundant case base reserves accounted for approximately 40% of our favorable development with the remaining redundancy attributed primarily to the re-estimate of

incurred-but-not-reported loss reserves, after an additional year of development. As discussed above, we believe this IBNR development was caused, in part, by lower non-catastrophe related frequency patterns than we have experienced historically, a higher level of case base redundancies, and favorable loss development in our newer lines of business. The case base redundancy was due in part to our response to the loss reserve deficiencies for the December 31, 2002 loss reserves that were ultimately discovered during 2003. Both our property and liability lines developed a deficiency in 2003. Collectively, the December 31, 2002 loss reserves developed a deficiency of approximately 10 percent, or \$12 million, in 2003. This was due, in part, to the newer lines of business and the more volatile park and dealer liability lines, which we exited in 2001. In response to deficient development of reserves, management strengthened the company's loss reserves to reflect these changing development trends arriving at a best estimate of how these losses would ultimately settle. The higher levels of loss reserves, and their potential redundancy, were not fully contemplated in the incurred-but-not-reported loss reserves, because our experience had not been validated over an appropriate period of time.

As mentioned above, management considers trends or patterns in claim experience in determining its best estimate of loss reserves. Management regularly reviews the level of loss reserves against actual loss development. As part of the retrospective analysis, management compares actual development to our underlying assumptions and we consider these results in assessing whether any adjustments to the loss reserves are necessary. This retrospective review is the primary criteria used in refining the levels of loss reserves recorded in the financial statements. As part of this review, management also considers trends or patterns noted in management's regular discussions with internal and external consulting actuaries. We meet with our consulting actuary on a quarterly basis and have ongoing discussions as necessary. During the meetings with our consulting actuary, we use available statistical information to re-estimate prior period loss reserves which includes the development of the case base loss reserves. We also consider the summarized statistical results from previous meetings with our external actuary in refining our IBNR reserves. In addition, management meets quarterly with Claims and Product personnel to review ongoing business trends, claim frequency and severity statistics and other relevant developmental trends. We consider changes in our business, product mix, current events and any changes in case base claims reserving philosophies.

As previously mentioned, management engages a credentialed consulting actuary to affirm the recorded amount of loss reserves with an acceptable actuarial range. The consulting actuarial firm utilizes a variety of actuarial and statistical methods in determining the ultimate liabilities within acceptable actuarial range for loss reserves. These methods include, but are not limited to:

- The Incurred Loss Development Method
- The Paid Loss Development Method
- The Hindsight Average Claim Cost Method
- Bornhuetter/Ferguson (Paid and Incurred) Methods

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

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The table below provides a summary of these actuarial models along with an outline of the model advantages, disadvantages and the primary use of the model and key assumptions used on the models:

Model	Model Summary	Model Advantages	Model Disadvantages	Primary Use of Model	Key Assumptions
<b>Incurred Loss Development Method</b>	Historical loss reporting pattern is applied directly to the latest cumulative reported losses (paid plus case reserves) to estimate ultimate losses.	Tends to be responsive to changes in reported losses. May also provide more accurate estimate of ultimate losses for less mature years if historical levels of reserve accuracy are maintained.	May inaccurately react to a change in the adequacy of case reserves.	Principally used for property lines of business, including the property components of residential property lines. Model is also used for older accident years for liability components.	Historical loss development growth will be consistent from year to year. Often an average growth development factor will be utilized.
<b>Paid Loss Development</b>	Historical loss payment pattern is applied directly to the latest cumulative paid losses to estimate ultimate losses.	Estimates of ultimate losses are independent of case reserve adequacy and are unaffected by changes in case reserving practices.	The nature of liability payment patterns requires the application of large development factors to relatively small payments in most immature years.	Principally used for liability lines. It is more applicable in middle maturity accident years. This model is also used if there has been a change in case reserving philosophies.	Claims closing rates are consistent.
<b>Hindsight Average Claim Cost</b>	An estimate of the remaining reserves is divided by the number of open claims. These average claims costs are trended forward. From this average remaining claim cost we subtract the current average pending claim and then multiply the difference by the number of open claims. The result is a projection of IBNR.	The number of open claims is the basis of this approach and consequently, changes in reserve adequacy will not affect the result of this method.	Changes in claim closing rates will cause differences in historical averages (i.e. claim population at the same age of development is different.) This method does not reflect claims adjustment information, which is more important in older years.	Principally used for liability lines of business. It is appropriate for more recent accident years and may also be used if there has been a change in case reserving philosophies.	Ultimate settlement of open claims is consistent with historical trends. Claims closing rates are consistent.
<b>Bornhuetter / Ferguson</b>	This method bases the projection of losses on the loss ratio and percent of losses reported to date for an accident year. This model is often used in newer lines of business and may incorporate industry information.	This method is less sensitive than the incurred loss development method to the volatility that is present in the reported losses in the early stages of development.	Ignores current information as it assumes similar exposures and loss potential for all accident years, unless specific adjustments are made to account for changes.	Principally used for liability lines of business, although it may also be used for property lines of business for high catastrophe periods and lines of business that are less mature.	The selected initial expected loss ratio is reflective of the actual loss ratio. Reporting and/or payment patterns are consistent.

In determining the appropriate models to utilize for our various lines of business, our consulting actuary considers the following factors:

- Characteristics of the line of business (property or liability)
- The history of the lines of business
- The number of years of company specific historical development data
- The age of accident year
- Other specific operating factors, such as changes in claims reserving philosophies or changes in claims personnel management

Generally, the incurred loss development method is the primary method used by our external actuary in determining the ultimate liability for the property lines of business. For our liability lines of business, our consulting actuary will generally utilize estimates from several of the models listed above and develop a blended average. This process requires significant judgment from our credentialed actuary and more emphasis may be applied to one model based on the judgment of the actuary.

The Company's philosophy is to adequately reserve our case base claims in a consistent manner. We regularly monitor the development of our case base claims and make appropriate adjustments to our recorded reserve balances and in our reserving practices. In addition, the following factors contribute to the variability in establishing case base loss reserves:

- The timing of information received. As more information becomes available, (i.e., through physical inspections, actual claim settlement, etc.) case base reserves are adjusted appropriately to reflect current information.
- Liability claims, by their very nature, are less obvious and more complex than property claims and, therefore, the reserving process requires more judgment. Liability losses often involve multiple parties, can more often be subject to litigation and often do not involve immediately apparent property damage. As a consequence, reserving for such losses requires more estimation and judgment than the property lines.
- The increase in demand for replacement materials and labor (demand surge), specifically after a large scale catastrophic event, which may contribute to inadequate case base reserve.

IBNR loss reserves are approximately 25 percent of the net property and casualty loss reserves, while case base loss reserves represent approximately 75 percent of the net property and casualty reserve balance. The primary criteria that management considers in determining its best estimate for loss reserves includes trends and patterns in the actual claims settling process, historical development patterns, trends and patterns noted in regular discussion with internal and external actuaries, and changes in our business, product mix or our case base claims reserving process.

In order to determine an acceptable actuarial range of loss reserves, the consulting actuary utilizes various statistical models. The most significant assumptions relate to the development factors which are utilized to predict the ultimate losses expected to be incurred. The consulting actuary utilizes historical development factors, including the use of 3- and 5-year historical development averages to estimate the ultimate liability. Our consulting affirming actuary utilizes development factors that are applicable to certain lines of business based on their risk characteristics (i.e., property, liability, motorcycle, excess and surplus). Additionally, development patterns are developed for each accident year. The development factors that are used by the actuaries are generally based on our historical patterns, rather than the development from any one year, which balances stability and responsiveness in developing age to age factors. For example, in determining the 2005 loss reserves, the most recent favorable one year development patterns were considered as part of historical averages. However, the impacts of the latest one-year favorable development factors were only partially recognized in the external actuary's contemplation of loss reserves. As development factors continue to emerge they will be a larger part of the historical three- and five-year averages, and will be more heavily weighted when reflected in the range of our affirming external actuary. For example, we have experienced more favorable development patterns over the last couple of years in our motorcycle coverages than our historical patterns would indicate.

Given the way in which we assess the adequacy of our loss reserves, it is not practicable to individually isolate and quantify the impact of specific factors attributable to key assumptions as many of these items are inter-related and are also offset by other significant factors such as frequency and severity.

Both management and the consulting actuary utilize various assumptions for loss adjustment expense and salvage and subrogation, and are based on historical averages. However, these assumptions have not changed significantly and have not materially affected management's best estimate of loss reserve or the external actuary's acceptable actuarial range of insurance loss reserves.

Based on the considerations noted above, and our historical loss reserve development patterns, we believe it is reasonably likely that our December 31, 2006 net property and casualty loss reserves will develop with a redundancy in the range of 5 percent to 15 percent, although it is possible that the actual development will be more or less. A chart outlining the after-tax earnings impact of reasonably likely redundancies is shown below. The potential earnings impact of the 2006 loss reserves redundancy on our 2007 after-tax earnings assumes no development, positive or negative, relative to the December 31, 2007 loss reserves.

Potential Percent Redundant	Potential After-Tax Earnings Impact
5%	\$ 4.5 million
10%	\$ 9.0 million
15%	\$13.5 million

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

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While management believes the amounts are fairly stated, the ultimate liability, once fully developed, may be more than or less than the recorded amount. If the ultimate pay outs would significantly exceed the expected amounts, the Company has several potential options to utilize in order to satisfy the additional obligations. For example, the Company could liquidate a portion of its investment portfolio or draw on conventional short-term credit lines available, at costs not exceeding prime rates. The Company believes either of these options would be sufficient to meet any increases in required loss payments. Slowness to recognize or respond to new or unexpected loss patterns, such as those caused by the risk factors listed in the Company's Safe Harbor Statement, could lead to a shortage in reserves, which would lead to a decrease in after-tax earnings.

#### Reinsurance Risks

American Modern participates in several reinsurance contracts with various reinsurers. The Company's primary reasons for entering reinsurance contracts are to reduce its exposure on particular risks and classes of risks as well as to protect against large accumulated losses resulting from catastrophes. In order to limit its exposure to certain levels of risks, the Company cedes varying portions of its written premiums to other insurance companies. As such, the Company limits its loss exposure to that portion of the insurable risk it retains. In addition, the Company pays a percentage of earned premiums to reinsurers in return for coverage against catastrophic losses. Additional reasons for entering reinsurance agreements include the following:

1. To reduce total statutory liabilities to a level appropriate for American Modern's capital and surplus.
2. To provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted.
3. To facilitate relationships with business partners who want to participate in the insurance risk through their own reinsurance companies.

The Company utilizes excess of loss reinsurance programs in order to reduce its exposure on particular risks and classes of risks (excess of loss per risk) as well as to protect against large accumulated losses resulting from catastrophes (excess of loss per occurrence). Under excess reinsurance, the insurer limits its liability to all or a particular portion of a predetermined deductible or retention. Therefore, the reinsurer's portion of the loss depends on the size of the loss.

Excess of Loss per occurrence reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on all losses arising from a single occurrence. The reinsurer pays claims in excess of the retention limits. The primary purpose of this reinsurance for American Modern is to protect the Company from the accumulation of losses arising from hurricanes or any other widespread weather related disaster. This reinsurance is also known as catastrophe reinsurance.

The Company's reinsurance treaties are prospective reinsurance agreements, contain no adjustable features, and do not include any profit sharing provisions. The costs associated with these reinsurance treaties are calculated and expensed based on the subject earned premium recorded in revenue multiplied by the corresponding rate. Any ceding commission is recorded according to the terms of the reinsurance treaty based on the percentage of the corresponding premiums. Ceded commissions are deferred and recognized as income over the life of the corresponding policies. The term is typically no more than twelve months due to the short-tail nature of our business. The costs associated with our catastrophe reinsurance program are generally amortized over the term of the coverage on a pro-rata basis.

Due to the nature of our non-catastrophe related reinsurance programs, the results of operations related to these programs did not significantly fluctuate during the three year period ended December 31, 2006.

However, our operating results were impacted to varying degrees by our catastrophe reinsurance program. Catastrophe reinsurance costs, including reinstatements, totaled \$25.8 million, \$31.9 million and \$16.9 million during 2006, 2005 and 2004, respectively. The Company's gross catastrophe losses for 2006, 2005 and 2004 were \$41.9 million, \$232.1 million and \$67.1 million, respectively, of which \$7.4 million, \$179.4 million and \$21.1 million, respectively, were recovered through our catastrophe reinsurers.

Based on our estimates as of December 31, 2006, Hurricane Katrina, the costliest storm in U.S history, exceeded the limits of the Company's 2005 catastrophe reinsurance program by approximately \$8.0 million in 2006, which impacted after tax earnings by approximately \$5.2 million.

Our 2006 catastrophe reinsurance structure was similar to the 2005 program with a \$3.0 million increase in retention, from \$7 million to \$10 million, and the purchase of an additional \$40 million of protection on top of our previous \$110 million cover. Due to the volatile weather patterns of 2005, we absorbed a significant increase in our base reinsurance cost in 2006 that nearly doubled the base cost of 2005. This increase, along with the additional cover, adversely impacted our 2006 pre-tax earnings by approximately \$12.0 million, or \$0.40 per share (diluted).

Our 2007 catastrophe reinsurance program is similar to the 2006 structure, but includes an additional \$50 million layer of protection on top of our previous \$150 million cover. The cost of our base catastrophe reinsurance program, which includes the purchase of the additional cover, will adversely impact our 2007 earnings by approximately \$0.16 per share (diluted).

While the hurricane activity over the past couple of years has significantly increased the cost of obtaining reinsurance, our strong relationships with our reinsurers have allowed us to provide exposure management that is consistent with our overall risk management strategy. In addition, our strong relationships with our reinsurers and our disciplined overall exposure management philosophy, combined with the financial strength of these reinsurers (as of December 31, 2006, approximately 85%

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of the Company's catastrophe reinsurers had an A.M. Best rating of "A-" or better), allow us to be confident that we will be able to effectively manage our exposures in the future.

If a reinsurer fails to honor its obligations, American Modern could suffer additional losses as the reinsurance contracts do not relieve American Modern of its obligations to policyholders. American Modern and its independent reinsurance broker regularly conduct "market security" evaluations of both its current and prospective reinsurers. Such evaluations include a complete review of each reinsurer's financial condition along with an assessment of credit risk concentrations arising from similar geographic regions, activities or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. The specific evaluation procedures include, but are not limited to, reviewing the periodic financial statements and ratings assigned to each reinsurer from rating agencies such as S&P, Moody's and A.M. Best.

In addition, American Modern may, in some cases, require reinsurers to establish trust funds and maintain letters of credit to further minimize possible exposures. All reinsurance amounts owed to American Modern are current and management believes that no allowance for uncollectible accounts related to this recoverable is necessary. Management also believes there is no significant concentration of credit risk arising from any single reinsurer. The Company also assumes a limited amount of business on certain reinsurance contracts. Related premiums and loss reserves are recorded based on records supplied by the ceding companies.

*Other-Than-Temporary Impairment of Investment Securities*

American Modern invests in various securities including U.S. Government securities, corporate debt securities, and corporate stocks. Investment securities in general are exposed to various risks such as interest rate, credit, and overall market volatility. Due to the level of risk associated with these securities, it is reasonably possible that changes in the value of investment securities will occur in the near term and that such changes could be material.

In order to identify other-than-temporary impairments, we conduct quarterly comprehensive reviews of individual portfolio holdings that have a market value less than their respective carrying value. As part of our review for other-than-temporary impairment, we track the respective carrying values and market values for all individual securities with an unrealized loss. We, with the assistance of our external professional money managers, apply both quantitative and qualitative criteria in our evaluation, including facts specific to each individual investment such as, but not limited to, the length of time the fair value has been below the carrying value, the extent of the decline, our intent to sell or hold the security, the expectation for each individual security's performance, the credit worthiness and related liquidity of the issuer and the issuer's business sector.

The evaluation for other-than-temporary impairment requires a significant amount of judgment. As such, there are a number of risks and uncertainties inherent in the process of

monitoring for potential impairments and determining if a decline is other-than-temporary. These risks and uncertainties include the risks that:

1. The economic outlook is worse than anticipated and has a greater adverse impact on a particular issuer than anticipated.
2. Our assessment of a particular issuer's ability to meet all of its contractual obligations changes based on changes in the facts and circumstances related to the issuer.
3. New information is obtained or facts and circumstances change that cause a change in our ability or intent to hold a security to maturity or until it recovers in value.

When a security is considered other-than-temporarily impaired, we monitor trends or circumstances that may impact other material investments in our portfolio. For example, we review any other securities that are held in the portfolio from the same issuer and also consider any circumstances that may impact other securities of issuers in the same industry. At December 31, 2006, we had no significant concentration of unrealized losses in any one issuer, industry or sector.

For fixed income and equity securities, we consider the following factors, among others, to determine if a security is other-than-temporarily impaired:

- the extent and duration to which market value is less than cost
- historical operating performance of the security
- issuer news releases, including those disclosing that the issuer has committed an event of default (missed payment beyond grace period, bankruptcy filing, loss of principle customer or supplier, debt downgrade, disposal of segment, etc.)
- near term prospects for improvement of the issuer and/or its industry to include relevant industry conditions and trends
- industry research and communications with industry specialists
- third party research reports
- credit rating reports
- financial models and expectations
- discussions with issuer's management by investment manager
- our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery
- time to conversion with respect to a mandatory convertible security

For fixed income securities, we also consider the following factors:

- the recoverability of principal and interest
- the issuer's ability to continue to make obligated payments to security holders
- the current interest rate environment

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

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The investment portfolio is comprised of various asset classes which are independently managed by external professional portfolio managers under the oversight and guidelines established by our investment committee. We evaluate the performance of the portfolio managers relative to benchmarks we believe appropriate given the asset class. Investment managers will manage the portfolio under these guidelines to maximize the return on their investment class. As part of their investment strategy, the investment managers will buy and sell securities based on changes in the availability of, and the yield on, alternative investments. Investment managers may also buy and sell investments to diversify risk, attain a specific characteristic such as duration or credit quality, rebalance or reposition the portfolio or for a variety of other reasons.

It is our intent, and thus the intent of our investment managers, to hold securities that have an unrealized gain or loss. For the securities with an unrealized loss, which in our judgment we believe to be temporary, it is our intent to hold the security for a period of time that will allow the security to recover in value. While the Company has the ultimate authority regarding sales of securities, investment managers may sell certain securities and reinvest the proceeds if they believe returns would be enhanced by doing so, in which case the unrealized gain or loss will be recognized as a realized gain or loss. As part of our comprehensive quarterly review for other than temporary impairment, the Company asks investment managers to identify any securities in which they have the intent to sell in the near term. In the case where investment managers have indicated their intent to sell a security in the near term and there is an unrealized loss, we record an other-than-temporary impairment at the balance sheet date, if such date is prior to the sale of the security. At December 31, 2006, we had no securities with an unrealized loss for which a decision was made to sell in the near term.

For the years ended December 31, 2006, 2005 and 2004, we incurred no losses related to other-than-temporary impairments. Impairment charges, if incurred, would be included in the consolidated financial statements in "net realized investment gains (losses)."

#### *Defined Benefit Pension Plans*

Midland maintains defined benefit pension plans for a limited number of active participants. The defined benefit pension plans are not open to employees hired after March 31, 2000. The pension expense is calculated based upon a number of actuarial assumptions, including an expected

long-term rate of return and a discount rate. In determining our expected long-term rate of return and our discount rate, we evaluate input from our actuaries, asset allocations, long-term bond yields and historical performance of the invested pension assets over a ten-year period. If other assumptions were used, the amount recorded as pension expense would be different from our current estimate.

#### **New Accounting Standards**

In October 2005, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 05-1. SOP-05-1 provides accounting guidance for deferred policy acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Statement of Financial Accounting Standards ("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." SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. The provisions of SOP 05-1 are effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The SOP is not expected to have a material impact on the Company's Consolidated Financial Position or Results of Operations.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140," which resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." SFAS No. 155, among other things, permits the fair value remeasurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133; and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS No. 155 is effective for all financial instruments acquired or issued in a fiscal year beginning after September 15, 2006. The Company is currently assessing the impact of SFAS No. 155 on its consolidated financial position and results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect the adoption of this new pronouncement to have a material effect on its financial position or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company is assessing the impact that SFAS 157 will have on its consolidated financial statements.

Also in September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statement No. 87, 88, 106 and 132(R)" ("SFAS 158"). This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The Standard also requires recognition in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. The recognition and disclosure elements of SFAS 158 are effective for fiscal years ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The adoption of SFAS 158 resulted in a reduction of shareholders' equity of \$3.6 million, net of tax, at December 31, 2006.

### **Impact of Inflation**

We do not consider the impact of the change in prices due to inflation to be material in the analysis of our overall operations.

## **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk that we will incur investment losses due to adverse changes in market rates and prices. Our market risk exposures are substantially related to the Company's investment portfolio and changes in interest rates and equity prices. Each risk is defined in more detail as follows.

Interest rate risk is the risk that the Company will incur economic losses due to adverse changes in interest rates. The risk arises from many of the Company's investment activities, as the Company invests substantial funds in interest-sensitive assets. The Company manages the interest rate risk inherent in its investment assets relative to the interest rate risk inherent in its liabilities. One of the measures the Company uses to quantify this exposure is duration. By definition, duration is a measure of the sensitivity of the fair value of a fixed income portfolio to changes in interest rates. Based upon the 5.0 year duration of the Company's fixed income portfolio as of December 31, 2006, management estimates that a 100 basis point increase in interest rates would decrease the market value of its \$801.7 million debt security portfolio by 5.0%, or \$40.1 million.

Equity price risk is the risk that the Company will incur economic losses due to adverse changes in a particular stock or stock index. The Company's equity exposure consists primarily of declines in the value of its equity security holdings. As of December 31, 2006, the Company had \$229.7 million in equity holdings, including \$88.8 million of U.S. Bancorp common stock. A 10% decrease in the market value of U.S. Bancorp's common stock would decrease the fair value of its equity portfolio by approximately \$8.9 million. As of December 31, 2006, the remainder of the Company's portfolio of equity securities had a beta coefficient (a measure of stock price volatility) of 0.95. This means that, in general, if the S&P 500 Index decreases by 10%, management estimates that the fair value of the remaining equity portfolio will decrease by 9.5%.

The active management of market risk is integral to the Company's operations. The Company has investment guidelines that define the overall framework for managing market and other investment risks, including the accountabilities and controls over these activities.

## CONSOLIDATED STATEMENTS OF INCOME

THE MIDLAND COMPANY AND SUBSIDIARIES

	Years Ended December 31,		
	2006	2005	2004
<i>(Amounts in thousands, except per share data)</i>			
Revenues:			
Premiums earned	\$675,864	\$631,864	\$677,584
Other insurance income	12,929	12,600	13,780
Net investment income	42,223	40,519	37,165
Net realized investment gains	8,445	6,262	9,933
Transportation	49,807	42,185	45,379
Total	789,268	733,430	783,841
Costs and Expenses:			
Losses and loss adjustment expenses	307,503	286,662	348,611
Commissions and other policy acquisition costs	209,719	198,585	201,155
Operating and administrative expenses	127,236	112,329	108,536
Transportation operating expenses	41,792	36,986	43,266
Interest expense	5,164	5,967	5,169
Total	691,414	640,529	706,737
Income Before Federal Income Tax	97,854	92,901	77,104
Provision for Federal Income Tax	27,159	27,575	22,866
Net Income	\$ 70,695	\$ 65,326	\$ 54,238
Basic Earnings Per Share of Common Stock	\$ 3.70	\$ 3.46	\$ 2.91
Diluted Earnings Per Share of Common Stock	\$ 3.60	\$ 3.37	\$ 2.83

See notes to consolidated financial statements.

## CONSOLIDATED BALANCE SHEETS

THE MIDLAND COMPANY AND SUBSIDIARIES

<i>(Amounts in thousands)</i>	December 31,	
	2006	2005
<b>ASSETS</b>		
Marketable Securities:		
Fixed income (amortized cost, \$792,998 at December 31, 2006 and \$743,354 at December 31, 2005)	\$ 801,682	\$ 751,651
Equity (cost, \$117,659 at December 31, 2006 and \$109,020 at December 31, 2005)	229,695	195,445
Total	1,031,377	947,096
Cash	5,059	3,368
Accounts Receivable—Net	148,204	137,125
Reinsurance Recoverables and Prepaid Reinsurance Premiums	128,506	132,737
Property, Plant and Equipment—Net	118,879	89,888
Deferred Insurance Policy Acquisition Costs	99,277	88,374
Other Assets	38,226	29,525
Total Assets	<b>\$1,569,528</b>	<b>\$1,428,113</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Unearned Insurance Premiums	\$ 445,324	\$ 395,007
Insurance Loss Reserves	221,639	254,660
Insurance Commissions Payable	46,593	41,900
Funds Held Under Reinsurance Agreements and Reinsurance Payables	15,139	11,655
Long-Term Debt	66,508	67,766
Notes Payable	17,937	20,005
Deferred Federal Income Tax	47,197	38,350
Other Payables and Accruals	110,445	90,393
Junior Subordinated Debentures	24,000	24,000
Total Liabilities	994,782	943,736
Commitments and Contingencies	—	—
Shareholders' Equity:		
Common stock (issued and outstanding: 19,224 shares at December 31, 2006 and 18,964 shares at December 31, 2005 after deducting treasury stock of 3,782 shares and 4,042 shares, respectively)	959	959
Additional paid-in capital	65,669	57,061
Retained earnings	477,145	411,210
Accumulated other comprehensive income	72,346	57,863
Treasury stock—at cost	(41,373)	(42,716)
Total Shareholders' Equity	574,746	484,377
Total Liabilities and Shareholders' Equity	<b>\$1,569,528</b>	<b>\$1,428,113</b>

See notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

THE MIDLAND COMPANY AND SUBSIDIARIES

(Amounts in thousands)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Unvested Restricted Stock Awards	Total	Compre- hensive Income
<b>Balance, December 31, 2003</b>	\$911	\$23,406	\$299,752	\$73,455	\$(41,442)	\$(24)	\$356,058	
Comprehensive income:								
Net income			54,238				54,238	\$54,238
Increase in unrealized gain on marketable securities, net of federal income tax of \$518				966			966	966
Other, net of federal income tax of \$(750)				(1,394)			(1,394)	(1,394)
Total comprehensive income								<u>\$53,810</u>
Common stock issuance	48	25,022					25,070	
Purchase of treasury stock					(2,918)		(2,918)	
Issuance of treasury stock for options exercised and employee savings plan		1,642			1,325		2,967	
Cash dividends declared			(3,849)				(3,849)	
Federal income tax benefit related to the exercise or granting of stock awards		1,114					1,114	
Amortization and cancellation of unvested restricted stock awards						24	24	
<b>Balance, December 31, 2004</b>	959	51,184	350,141	73,027	(43,035)	—	432,276	
Comprehensive income:								
Net income			65,326				65,326	\$65,326
Decrease in unrealized gain on marketable securities, net of federal income tax of \$(7,473)				(13,877)			(13,877)	(13,877)
Other, net of federal income tax of \$(692)				(1,287)			(1,287)	(1,287)
Total comprehensive income								<u>\$50,162</u>
Purchase of treasury stock					(1,839)		(1,839)	
Issuance of treasury stock for options exercised and employee savings plan		3,520			2,158		5,678	
Cash dividends declared			(4,257)				(4,257)	
Federal income tax benefit related to the exercise or granting of stock awards		455					455	
Stock option expense		1,902					1,902	
<b>Balance, December 31, 2005</b>	959	57,061	411,210	57,863	(42,716)	—	484,377	
Comprehensive income:								
Net income			70,695				70,695	\$70,695
Increase in unrealized gain on marketable securities, net of federal income tax of \$9,099				16,899			16,899	16,899
Other, net of federal income tax of \$655				1,216			1,216	1,216
Total comprehensive income								<u>\$88,810</u>
SFAS 158 pension adjustment, net of federal income tax of \$(1,956)				(3,632)			(3,632)	
Purchase of treasury stock					(2,082)		(2,082)	
Issuance of treasury stock for options exercised and employee savings plan		4,656			3,425		8,081	
Cash dividends declared			(4,760)				(4,760)	
Federal income tax benefit related to the exercise or granting of stock awards		1,420					1,420	
Stock option expense		2,532					2,532	
<b>Balance, December 31, 2006</b>	<b>\$959</b>	<b>\$65,669</b>	<b>\$477,145</b>	<b>\$72,346</b>	<b>\$(41,373)</b>	<b>\$ —</b>	<b>\$574,746</b>	

See notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

THE MIDLAND COMPANY AND SUBSIDIARIES

(Amounts in thousands)	Years Ended December 31,		
	2006	2005	2004
<b>Cash Flows from Operating Activities:</b>			
Net income	\$ 70,695	\$ 65,326	\$ 54,238
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,412	10,521	10,867
Stock-based compensation	5,616	3,943	1,852
Net realized investment gains	(7,175)	(5,870)	(9,169)
Changes in:			
Reinsurance recoverables and prepaid reinsurance premiums	13,056	(45,011)	(16,736)
Net accounts receivable	(10,582)	(23,146)	(19,971)
Insurance loss reserves	(35,739)	21,745	28,082
Unearned insurance premiums	28,576	4,560	6,578
Other assets	(4,320)	(3,878)	(4,315)
Insurance commissions payable	4,683	(1,167)	12,545
Deferred insurance policy acquisition costs	(4,822)	2,049	(2,550)
Funds held under reinsurance agreements and reinsurance payables	3,334	(2,117)	6,794
Other accounts payable and accruals	13,943	(781)	18,680
Provision (benefit) for deferred federal income tax	(408)	(1,088)	407
Other—net	783	2,044	1,604
Net cash provided by operating activities	87,052	27,130	88,906
<b>Cash Flows from Investing Activities:</b>			
Acquisitions, net of cash acquired	(15,174)	—	—
Purchase of marketable securities	(331,244)	(504,809)	(617,105)
Sale of marketable securities	248,355	457,815	407,729
Maturity of marketable securities	27,367	86,083	76,946
Decrease (increase) in cash equivalent marketable securities	25,800	(32,558)	15,992
Acquisition of property, plant and equipment	(50,832)	(32,435)	(11,699)
Proceeds from sale of property, plant and equipment	13,157	890	2,243
Net cash used in investing activities	(82,571)	(25,014)	(125,894)
<b>Cash Flows from Financing Activities:</b>			
Repayment of notes payable	(2,068)	(13,172)	(448)
Repayment of long-term debt	(1,258)	(1,903)	(3,488)
Issuance of long-term debt	—	10,940	—
Dividends paid	(4,651)	(4,155)	(3,723)
Issuance of treasury stock	6,103	4,523	2,967
Purchase of treasury stock	(2,082)	(1,839)	(2,918)
Excess tax benefits from exercise of stock options	1,166	—	—
Proceeds from common stock issuance	—	—	25,070
Issuance of junior subordinated debentures	—	—	24,000
Net cash provided by (used in) financing activities	(2,790)	(5,606)	41,460
<b>Net Increase (Decrease) in Cash</b>	<b>1,691</b>	<b>(3,490)</b>	<b>4,472</b>
<b>Cash at Beginning of Period</b>	<b>3,368</b>	<b>6,858</b>	<b>2,386</b>
<b>Cash at End of Period</b>	<b>\$ 5,059</b>	<b>\$ 3,368</b>	<b>\$ 6,858</b>
<b>Interest Paid</b>	<b>\$ 5,029</b>	<b>\$ 5,753</b>	<b>\$ 4,470</b>
<b>Income Taxes Paid</b>	<b>\$ 29,625</b>	<b>\$ 24,600</b>	<b>\$ 22,869</b>

Treasury stock issued under the Company's performance stock award plan amounted to \$1,978 and \$1,155 for 2006 and 2005, respectively.

See notes to consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

THE MIDLAND COMPANY AND SUBSIDIARIES

Years Ended December 31, 2006, 2005 and 2004

## 1. GENERAL INFORMATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Midland Company (the "Company" or "Midland") operates in two industries—insurance and transportation with the most significant business activities being in insurance. Midland's insurance operations are conducted through its wholly-owned subsidiary, American Modern Insurance Group, Inc. ("American Modern"). M/G Transport Services, Inc. and MGT Services, Inc. (collectively "M/G Transport") operates a fleet of dry cargo barges for the movement of dry bulk commodities such as petroleum coke, ores, barite, sugar and other cargos primarily on the lower Mississippi River and its tributaries.

The accounting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make numerous estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. The accompanying consolidated financial statements include estimates for items such as insurance loss reserves, income taxes, various other liability accounts and deferred insurance policy acquisition costs. Actual results could differ from those estimates. Policies that affect the more significant elements of the consolidated financial statements are summarized below.

**Principles of Consolidation**—The consolidated financial statements include the accounts of the Company and all subsidiary companies. Material intercompany balances and transactions have been eliminated.

**Marketable Securities**—Marketable securities are categorized as fixed income securities (cash equivalents, debt instruments and preferred stocks having scheduled redemption provisions) and equity securities (common, convertible and preferred stocks which do not have redemption provisions). The Company classifies all fixed income and equity securities as available-for-sale and carries such investments at market value. Unrealized gains or losses on investments, net of related income taxes, are included in shareholders' equity as an item of accumulated other comprehensive income. Realized gains and losses on sales of investments are recognized in income on a specific identification basis. Embedded derivatives are valued separately and the change in market value of the derivatives is included in Net Realized Investment Gains on the Consolidated Statements of Income.

Available-for-sale securities are reviewed quarterly for possible other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as the length of time the fair value has been below cost, the expectation for that security's performance, the

credit worthiness of the issuer and the Company's intent to sell or its ability to hold the security to maturity. A decline in value that is considered to be other-than-temporary is recorded as a loss within Net Realized Investment Gains in the Consolidated Statements of Income.

**Property and Depreciation**—Property, plant and equipment are recorded at cost. The Company periodically measures fixed assets for impairment. Depreciation and amortization are generally calculated over the estimated useful lives of the respective properties (buildings and equipment – 15 to 35 years, furniture and equipment – 3 to 7 years, and barges – 23 years).

During 2006, the Company performed an extensive review of its useful life and salvage value estimates as they relate to M/G Transport's barges. As a result of this review, the Company determined that the useful lives of the barges should be extended from 20 years to 23 years. In addition, the Company determined that the salvage values of each barge should be increased from \$10,000 to \$30,000. Both of these changes were implemented prospectively and were effective on October 1, 2006. The effect of this change in accounting estimate on the Company's net income was \$146,000 for the fourth quarter of 2006.

The Company has implemented several modules and is continuing the process of developing an information technology system for its insurance operations. The system is known as modernLINK® and its development began in 2000 and will continue over the next several years. Certain costs that are directly related to this system are capitalized. As components of the system are implemented and placed into service, depreciation commences using the straight-line method over periods ranging from four to eight years.

**Goodwill and Other Intangibles**—In July 2006, the Company acquired all of the outstanding stock of Southern Pioneer Life Insurance Company, a privately held insurance company located in Trumann, Arkansas. Operating results emanating from this purchase since July 2006 are reported in the "All other insurance" segment.

As a result of this acquisition, the Company recorded \$3.2 million in goodwill and \$1.7 million in other intangible assets. The other intangible assets will be amortized over periods ranging from five to fifteen years. Future amortization expense will equal (amounts in 000's): \$127 – 2007; \$127 – 2008; \$127 – 2009; \$127 – 2010; \$117 in 2011 and \$1,056 – thereafter.

In addition to the \$3.2 million of goodwill mentioned above, the Company also has \$2.1 million of goodwill related to past business combinations. The goodwill balances are recorded in Other Assets on the Company's Consolidated Balance Sheets. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", the Company accounts for goodwill under the impairment approach. Based on the Company's impairment review, no impairment charges were necessary for 2006, 2005 or 2004.

**Federal Income Tax**—Deferred federal income taxes are recognized to reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for federal income tax purposes. The Company continually reviews deferred tax assets to determine the necessity of a valuation allowance.

The Company files a consolidated federal income tax return which includes all subsidiaries.

**Insurance Income**—Premiums for physical damage and other property and casualty related coverages, net of premiums ceded to reinsurers, are recognized as income on a pro-rata basis over the lives of the policies. Credit accident and health and credit life premiums are recognized as income over the lives of the policies in proportion to the amount of insurance protection provided. The Company does not consider anticipated investment income in determining premium deficiencies (if any) on short-term contracts. Policy acquisition costs, primarily pre-paid commission expenses and premium taxes, are capitalized and expensed over the terms of the related policies on the same basis as the related premiums are earned. Selling and administrative expenses that are not primarily related to premiums written are expensed as incurred.

**Insurance Loss Reserves**—Unpaid insurance losses and loss adjustment expenses include an amount determined from reports on individual cases and an amount, based on past experience and other assumptions, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amounts are fairly stated, the ultimate liability may be in excess of or less than the amounts provided. The methods of making such estimates and for establishing the resulting liabilities are continually reviewed and any adjustments resulting therefrom are included in earnings currently. Insurance loss reserves also include an amount for claim drafts issued but not yet paid. In addition, insurance loss reserves are presented net of amounts recoverable from salvage and subrogation and include amounts recoverable from reinsurance for which receivables are recognized.

**Allowance for Losses**—Provisions for losses on receivables are made in amounts deemed necessary to maintain adequate reserves to cover probable future losses.

**Reinsurance**—In order to limit its exposure to certain levels of risks, the Company cedes varying portions of its written premiums to other insurance companies. As such, the Company limits its loss exposure to that portion of the insurable risk it retains. In addition, the Company pays a percentage of earned premiums to reinsurers in return for coverage against catastrophic losses. However, if a reinsurer fails to honor its obligations, American Modern could suffer additional losses as the reinsurance contracts do not relieve American Modern of its obligations to policyholders.

American Modern and its independent reinsurance brokers regularly conduct “market security” evaluations of both its current and prospective reinsurers. Such evaluations include a complete review of each reinsurer’s financial condition along with an assessment of credit risk concentrations arising from similar geographic regions, activities or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. The specific evaluation procedures include, but are not limited to, reviewing the periodic financial statements and ratings assigned to each reinsurer from rating agencies such as S&P, Moody’s and A.M. Best. During 2006, approximately 85% of the Company’s catastrophe reinsurers had an A.M. Best or S&P rating of “A” or higher.

In addition, American Modern may, in some cases, require reinsurers to establish trust funds and maintain letters of credit to further minimize possible exposures. All reinsurance amounts owed to American Modern are current and management believes that no allowance for uncollectible accounts related to this recoverable is necessary. Management also believes there is no significant concentration of credit risk arising from any single reinsurer.

The Company also assumes a limited amount of business on certain reinsurance contracts. Related premiums and loss reserves are recorded based on records supplied by the ceding companies.

**Transportation Revenues**—Revenues for river transportation activities are recognized when earned. If freight services are in process at the end of a reporting period, an allocation of revenue between reporting periods is made based on relative transit time in each reporting period with expenses recognized as incurred.

**Statements of Cash Flows**—For purposes of the consolidated statements of cash flows, the Company defines cash as cash held in operating accounts at financial institutions. The amounts reported in the consolidated statements of cash flows for the purchase, sale or maturity of marketable securities do not include cash equivalents.

**Fair Value of Financial Instruments**—The carrying values of cash, receivables, short-term notes payable, trade accounts payable and any financial instruments included in other assets and accrued liabilities approximate their fair values principally because of the short-term maturities of these instruments. Generally, the fair value of investments, including derivatives, is considered to be the market value which is based on quoted market prices. The fair value of long-term debt is estimated using interest rates that are currently available to the Company for issuance of debt with similar terms and maturities.

**Derivative Instruments**—The Company accounts for its derivatives under Statement of Financial Accounting Standards (“SFAS”) 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended. The standard requires recognition of all derivatives as either assets or liabilities in the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

balance sheet and requires measurement of those instruments at fair value through adjustments to either accumulated other comprehensive income or current earnings or both, as appropriate. During 2002, the Company entered into a series of interest rate swaps to convert \$30 million of floating rate debt to a fixed rate. The interest rate swaps were designated as a cash flow hedge and were deemed to be 100% effective. Thus, the changes in the fair value of the swap agreements are recorded as a separate component of shareholders' equity and have no impact on the Consolidated Statements of Income. The interest rate swap agreements ended during 2005 and, therefore, no balances were outstanding related to these derivatives at December 31, 2006 or 2005. At December 31, 2004, \$0.3 million in deferred losses, net of tax, related to this hedge were recorded in accumulated other comprehensive income.

**Stock Option and Award Plans**—Midland has various plans which provide for granting options and common stock to certain employees and independent directors of the Company and its subsidiaries. During the fourth quarter of 2005, the Company elected to early adopt SFAS 123 (Revised 2004), "Share-Based Payment" ("SFAS 123(R)") under the modified retrospective approach, restating only prior interim periods in fiscal 2005. As a result, the Company has applied SFAS 123(R) to new awards and to awards modified, repurchased or cancelled after January 1, 2005. Additionally, compensation cost for the portion of awards for which the requisite service had not been rendered, that were outstanding as of January 1, 2005, are being recognized as the requisite service is rendered on or after January 1, 2005 (generally over the remaining option vesting period). The compensation cost for that portion of awards has been based on the grant-date fair value of those awards as calculated previously for pro forma disclosures. Prior to the fourth quarter of 2005, the Company accounted for compensation expense related to such transactions using the "intrinsic value" based method under the provisions of Accounting Principles Board ("APB") Opinion No. 25 and its related interpretations. Midland's equity compensation plans are described more fully in Note 13.

The fair values of the 2006, 2005 and 2004 option grants were estimated on the date of the grant using the Black Scholes option-pricing model with the following (weighted average) assumptions:

	2006	2005	2004
Fair value of options granted	\$11.72	\$12.31	\$8.77
Dividend yield	0.9%	1.0%	1.0%
Expected volatility	28.9%	30.5%	31.6%
Risk free interest rate	4.5%	4.0%	3.6%
Expected life (in years)	7.0	7.5	7.0

Prior to 2005, Midland accounted for stock options using the "intrinsic value" method. Therefore, no compensation cost had been recognized for the stock option plans. Had the Company accounted for all stock based employee compensation

under the fair value method (SFAS 123), the Company's 2004 net income and earnings per share would have been reduced to the pro forma amounts indicated below (amounts in 000's, except per share data):

	Pro forma 2004
Net Income as Reported	<u>\$54,238</u>
Deduct: Total stock option employee compensation determined under fair value based method for all awards, net of related tax effects	<u>1,053</u>
Pro forma Net Income	<u>\$53,185</u>
<b>Average shares outstanding</b>	
Basic	18,618
Diluted	19,190
<b>Earnings per share</b>	
Basic—as reported	\$ 2.91
Basic—pro forma	2.86
Diluted—as reported	\$ 2.83
Diluted—pro forma	2.77

**New Accounting Standards**—In October 2005, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 05-1. SOP 05-1 provides accounting guidance for deferred policy acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Statement of Financial Accounting Standards ("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." SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. The provisions of SOP 05-1 are effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The SOP is not expected to have a material impact on the Company's Consolidated Financial Position or Results of Operations.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140," which resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." SFAS No. 155, among other things, permits the fair value remeasurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; clarifies which interest-only strips and principal-only strips are not subject to the

requirements of Statement 133; and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS No. 155 is effective for all financial instruments acquired or issued in a fiscal year beginning after September 15, 2006. The Company is currently assessing the impact of SFAS No. 155 on its consolidated financial position and results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect the adoption of this new pronouncement to have a material effect on its financial position or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The Company is assessing the impact that SFAS 157 will have on its consolidated financial statements.

Also in September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statement No. 87, 88, 106 and 132(R)" ("SFAS 158"). This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The Standard also requires recognition in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. The recognition and disclosure elements of SFAS 158 are effective for fiscal years ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The adoption of SFAS 158 resulted in a reduction of shareholders' equity of \$3.6 million, net of tax, at December 31, 2006.

## 2. MARKETABLE SECURITIES

2006	Thousands of Dollars			
	Cost or Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
<b>Debt Securities:</b>				
Governments	\$ 39,409	\$ 683	\$ 240	\$ 39,852
Mortgage Backed	118,379	751	897	118,233
Municipals	405,694	5,538	907	410,325
Corporates	164,921	5,182	1,426	168,677
Cash Equivalents	53,586	—	—	53,586
Other—Notes				
Receivable	1,048	—	—	1,048
Accrued Interest	9,961	—	—	9,961
<b>Total</b>	<b>792,998</b>	<b>12,154</b>	<b>3,470</b>	<b>801,682</b>
<b>Equity Securities</b>	<b>112,609</b>	<b>112,690</b>	<b>654</b>	<b>224,645</b>
Derivatives	3,884	—	—	3,884
Accrued Dividends	1,166	—	—	1,166
<b>Total</b>	<b>117,659</b>	<b>112,690</b>	<b>654</b>	<b>229,695</b>
<b>Total Marketable Securities</b>	<b>\$910,657</b>	<b>\$124,844</b>	<b>\$4,124</b>	<b>\$1,031,377</b>

2005	Thousands of Dollars			
	Cost or Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
<b>Debt Securities:</b>				
Governments	\$ 50,647	\$ 998	\$ 366	\$ 51,279
Mortgage Backed	112,105	601	1,446	111,260
Municipals	347,086	5,054	1,581	350,559
Corporates	155,363	6,445	1,408	160,400
Cash Equivalents	68,242	—	—	68,242
Other—Notes				
Receivable	1,137	—	—	1,137
Accrued Interest	8,774	—	—	8,774
<b>Total</b>	<b>743,354</b>	<b>13,098</b>	<b>4,801</b>	<b>751,651</b>
<b>Equity Securities</b>	<b>105,182</b>	<b>87,770</b>	<b>1,345</b>	<b>191,607</b>
Derivatives	2,843	—	—	2,843
Accrued Dividends	995	—	—	995
<b>Total</b>	<b>109,020</b>	<b>87,770</b>	<b>1,345</b>	<b>195,445</b>
<b>Total Marketable Securities</b>	<b>\$852,374</b>	<b>\$100,868</b>	<b>\$6,146</b>	<b>\$947,096</b>

At December 31 2006 and 2005, the fair value of the Company's investment in the common stock of US Bancorp, which exceeded 10% of the Company's shareholders' equity, was \$88.8 million and \$73.5 million, respectively. Also, at December 31, 2006 and 2005, the market value of the Company's investment portfolio includes approximately \$24.2 million and \$35.1 million, respectively, of convertible securities, some of which contain derivatives features.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

The following is investment information summarized by investment category (amounts in 000's):

	2006	2005	2004
Investment Income:			
Interest on Fixed Income Securities	\$ 37,435	\$ 35,942	\$ 32,523
Dividends on Equity Securities	6,983	6,688	6,547
Investment Expense	(2,195)	(2,111)	(1,905)
Net Investment Income	\$ 42,223	\$ 40,519	\$ 37,165
Net Realized Investment Gains (Losses):			
Fixed Income:			
Gross Realized Gains	\$ 2,832	\$ 3,822	\$ 5,121
Gross Realized Losses	(2,884)	(4,067)	(2,109)
Equity Securities:			
Gross Realized Gains	9,363	8,804	10,962
Gross Realized Losses	(866)	(2,297)	(4,041)
Net Realized Investment Gains	\$ 8,445	\$ 6,262	\$ 9,933
Change in Unrealized Investment Gains (Losses):			
Fixed Income	\$ 387	\$(16,828)	\$(2,594)
Equity Securities	25,611	(4,523)	4,078
Change in Unrealized Investment Gains (Losses)	\$ 25,998	\$(21,351)	\$ 1,484

Included in Net Realized Investment Gains (Losses) for 2006, 2005 and 2004 is the change in the fair value of derivative features of (amounts in 000's) \$1,041, \$392 and \$764 respectively.

The cost or amortized cost and approximate fair value of debt securities held at December 31, 2006, summarized by contractual maturities, are shown below. Actual maturities may differ from contractual maturities when there exists a right to call or prepay obligations with or without call or prepayment penalties (amounts in 000's).

	Cost or Amortized Cost	Fair Value
One year or less	\$ 75,564	\$ 75,609
After one year through five years	138,075	140,185
After five years through ten years	277,920	280,440
After ten years	301,439	305,448
Total	\$792,998	\$801,682

The Company's fixed income portfolio primarily consists of high quality investment grade securities and has an "AA" Standard & Poor's average quality rating at December 31, 2006.

The Company performs quarterly comprehensive reviews of individual fixed income and equity portfolio holdings that have a market value less than their respective carrying value. The Company, with the assistance of its external professional money managers, applies both quantitative and qualitative criteria in its evaluation of possible other-than-temporary impairment, including facts specific to each individual investment, including, but not limited to, the length of time the fair value has been below carrying value, the extent of the decline, the Company's intent to hold or sell the security, the expectation for each security's performance as well as prospects for recovery, the credit worthiness and related liquidity of the issuer and the issuer's business sector.

The following table shows the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2006 and 2005 (amounts in 000's):

	2006		
	Fair Value	Unrealized Losses	Number Securities
<b>Less Than 12 Months</b>			
Governments	\$ 4,204	\$ 15	5
Mortgage backed	25,243	98	42
Municipals	51,010	220	65
Corporates	48,912	607	72
Total Debt Securities	129,369	940	184
Equity Securities	8,420	481	18
Total	\$137,789	\$1,421	202
<b>12 Months or More</b>			
Governments	\$ 9,071	\$ 225	17
Mortgage backed	36,083	800	42
Municipals	68,008	687	77
Corporates	18,969	818	35
Total Debt Securities	132,131	2,530	171
Equity Securities	2,834	173	5
Total	\$134,965	\$2,703	176
<b>Total</b>			
	Fair Value	Unrealized Losses	Number Securities
Governments	\$ 13,275	\$ 240	22
Mortgage backed	61,326	898	84
Municipals	119,018	907	142
Corporates	67,881	1,425	107
Total Debt Securities	261,500	3,470	355
Equity Securities	11,254	654	23
Total	\$272,754	\$4,124	378

THE MIDLAND COMPANY AND SUBSIDIARIES

2005	Less Than 12 Months		
	Fair Value	Unrealized Losses	Number Securities
Governments	\$ 16,448	\$ 169	13
Mortgage backed	50,014	791	52
Municipals	136,681	1,293	99
Corporates	44,720	1,350	78
Total Debt Securities	247,863	3,603	242
Equity Securities	16,399	1,237	25
Total	\$264,262	\$4,840	267

	12 Months or More		
	Fair Value	Unrealized Losses	Number Securities
Governments	\$ 6,243	\$ 197	13
Mortgage backed	20,500	655	23
Municipals	10,207	288	19
Corporates	2,128	58	4
Total Debt Securities	39,078	1,198	59
Equity Securities	1,329	108	4
Total	\$ 40,407	\$1,306	63

	Total		
	Fair Value	Unrealized Losses	Number Securities
Governments	\$ 22,691	\$ 366	26
Mortgage backed	70,514	1,446	75
Municipals	146,888	1,581	118
Corporates	46,848	1,408	82
Total Debt Securities	286,941	4,801	301
Equity Securities	17,728	1,345	29
Total	\$304,669	\$6,146	330

### 3. ACCOUNTS RECEIVABLE—NET

Accounts receivable at December 31, 2006 and 2005 are generally due within one year and consist of the following (amounts in 000's):

	2006	2005
Insurance	\$138,227	\$119,250
Transportation	7,246	12,059
Other	3,513	6,591
Total	148,986	137,900
Less Allowance for Losses	782	775
Accounts Receivable—Net	\$148,204	\$137,125

At December 31, 2006 and 2005, the Company had outstanding receivables, all of which were current, from one of its customers of \$20.0 million and \$12.6 million, respectively.

### 4. PROPERTY, PLANT AND EQUIPMENT—NET

At December 31, 2006 and 2005, property, plant and equipment stated at original cost consist of the following (amounts in 000's):

	2006	2005
Land	\$ 1,491	\$ 1,491
Buildings, Improvements, Fixtures, etc.	91,034	70,128
Transportation Equipment	57,358	53,108
Software Development	40,255	31,267
Total	190,138	155,994
Less Accumulated Depreciation and Amortization	71,259	66,106
Property, Plant and Equipment—Net	\$118,879	\$ 89,888

Included in Buildings, Improvements, Fixtures, etc. in the above table is \$17.4 million and \$0.8 million of construction in progress for 2006 and 2005, respectively, related to the expansion of the Company's headquarters which is scheduled for completion in September 2007. The construction in progress amount includes \$0.3 million of capitalized interest for 2006. There was no capitalized interest at the end of 2005.

Included in Software Development in the above table is \$25.6 million and \$17.5 million of construction in progress for 2006 and 2005, respectively, related to the development of moderLINK, the Company's proprietary information systems and web enablement initiative. The construction in progress amount includes \$1.9 million and \$0.5 million of capitalized interest for 2006 and 2005, respectively.

Total rent expense related to the rental of equipment included in the accompanying Consolidated Statements of Income is (amounts in 000's) \$9,643 in 2006, \$3,808 in 2005 and \$3,756 in 2004. Future rentals under non-cancelable operating leases are approximately (amounts in 000's): \$2,886 – 2007; \$2,516 – 2008; \$2,466 – 2009; \$2,534 – 2010; \$2,534 in 2011 and \$20,347 – thereafter.

Depreciation expense recorded in 2006, 2005 and 2004 was (amounts in 000's): \$8,978, \$10,250 and \$10,043, respectively.

As of December 31, 2006 and 2005, the unamortized balance of modernLINK's software development costs was \$28.3 million and \$20.1 million, respectively.

### 5. DEFERRED INSURANCE POLICY ACQUISITION COSTS

Acquisition costs capitalized during 2006, 2005 and 2004 amounted to \$178.2 million, \$164.0 million and \$176.3 million, respectively. Amortization of deferred acquisition costs was \$167.3 million, \$166.1 million and \$173.8 million for 2006, 2005 and 2004, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

THE MIDLAND COMPANY AND SUBSIDIARIES

### 6. NOTES PAYABLE

The Company had conventional lines of credit with commercial banks of \$83 million at both December 31, 2006 and 2005 with \$10 million and \$14 million in use under these agreements at December 31, 2006 and 2005, respectively. Borrowings under these lines of credit constitute senior debt. Total commercial paper debt outstanding at December 31, 2006 and 2005 was \$7.9 million and \$6.0 million, respectively.

The aforementioned notes payable, together with outstanding commercial paper, had weighted average interest rates of 5.67% and 4.90% at December 31, 2006 and 2005, respectively.

### 7. LONG-TERM DEBT

Long-term debt at December 31, 2006 and 2005 is summarized as follows (amounts in 000's):

	2006	2005
Equipment Obligations, Due Through—		
4.89% August 13, 2008	\$ 5,441	\$ 6,108
5.12% December 11, 2008	974	1,088
5.51% May 20, 2012	10,235	10,712
Mortgage Notes, Due Through—		
6.31% December 20, 2007	13,858	13,858
Unsecured Notes Under a		
\$72 million Credit Facility—		
6.37% December 1, 2010	36,000	36,000
Total Obligations	<u>66,508</u>	67,766
Current Maturities	15,183	1,258
Non Current Portion	<u>\$51,325</u>	<u>\$66,508</u>

Equipment and real estate obligations are collateralized by transportation equipment and real estate with a net book value of \$39.6 million at December 31, 2006.

The aggregate amount of repayment requirements on long-term debt for the five years subsequent to 2006 are (amounts in 000's): 2007 – \$15,183; 2008 – \$6,125; 2009 – \$562; 2010 – \$36,593; 2011 – \$627; thereafter - \$7,418.

At December 31, 2006 and 2005, the carrying value of the Company's long-term debt approximated its fair value.

### 8. JUNIOR SUBORDINATED DEBENTURES

Wholly-owned subsidiary trusts of Midland have issued preferred trust securities and, in turn, purchased a like amount of subordinated debt which provides interest and principal payments to fund the trusts' obligations. The preferred trust securities are mandatorily redeemable upon maturity or redemption of the subordinated debt and are an obligation of Midland. The interest rate related to these securities is based on the 90 day LIBOR rate plus 3.5%, not to exceed 12.5% through the optional redemption dates in April and May 2009, respectively. The interest rates were 8.9% and 7.9% at December 31, 2006 and 2005, respectively. The junior subordinated debentures are due in 2034. They consist of \$12 million issued in April 2004 and \$12 million issued in May 2004 that are redeemable at the Company's option any time after April and May 2009, respectively.

### 9. FEDERAL INCOME TAX

The provision for federal income tax is summarized as follows (amounts in 000's):

	2006	2005	2004
Current provision	\$27,567	\$28,663	\$22,459
Deferred provision (benefit)	(408)	(1,088)	407
Total	<u>\$27,159</u>	<u>\$27,575</u>	<u>\$22,866</u>

The federal income tax provision for the years ended December 31, 2006, 2005 and 2004 is different from amounts derived by applying the statutory tax rates to income before federal income tax as follows (amounts in 000's):

	2006	2005	2004
Federal income tax at statutory rate	\$34,249	\$32,515	\$26,986
Tax effect of:			
Tax exempt interest and excludable dividend income	(7,081)	(5,447)	(4,401)
Other—net	(9)	507	281
Provision for federal income tax	<u>\$27,159</u>	<u>\$27,575</u>	<u>\$22,866</u>

Significant components of the Company's net deferred federal income tax liability are summarized as follows (amounts in 000's):

	2006	2005
Deferred tax liabilities:		
Deferred insurance policy acquisition costs	\$29,929	\$28,447
Unrealized gain on marketable securities	42,241	33,142
Accelerated depreciation	10,787	10,465
Other	6,101	3,759
Sub-total	<u>89,058</u>	<u>75,813</u>
Deferred tax assets:		
Unearned insurance premiums	24,711	23,368
Pension expense	1,499	1,019
Insurance loss reserves	4,489	5,135
Other	11,162	7,941
Sub-total	<u>41,861</u>	<u>37,463</u>
Deferred federal income tax	<u>\$47,197</u>	<u>\$38,350</u>

For 2006, 2005 and 2004, \$1,420, \$455 and \$1,114, respectively, of income tax benefits applicable to deductible compensation related to stock options exercised and restricted stock issued were credited to shareholders' equity.

## 10. REINSURANCE

Premium income in the accompanying consolidated statements of income include (amounts in 000's) \$63,580, \$53,343 and \$54,088 of earned premiums on assumed business and is net of \$127,368, \$112,777, and \$69,444 of earned premiums on ceded business for 2006, 2005, and 2004, respectively. Written premiums consist of the following (amounts in 000's):

	2006	2005	2004
Direct	\$764,012	\$676,517	\$680,061
Assumed	64,987	57,963	74,420
Ceded	(134,739)	(107,110)	(69,576)
Net	\$694,260	\$627,370	\$684,905

The net earned premium for the property and casualty group for 2006, 2005 and 2004 was \$659,379, \$621,235 and \$661,579, respectively.

The amounts of recoveries pertaining to property and casualty reinsurance contracts that were deducted from losses incurred during 2006, 2005 and 2004 were (amounts in 000's): \$30,722, \$189,407 and \$38,295, respectively.

## 11. INSURANCE LOSS RESERVES

Activity in the liability for unpaid insurance losses and loss adjustment expenses (excluding claim checks issued but not yet paid) for the property and casualty companies is summarized as follows (amounts in 000's):

	2006	2005	2004
Balance at January 1	\$201,910	\$197,666	\$169,931
Less reinsurance recoverables	53,844	31,364	20,453
Net balance at January 1	148,066	166,302	149,478
Incurred related to:			
Current year	310,065	317,978	359,504
Prior years	(10,010)	(36,375)	(17,551)
Total incurred	300,055	281,603	341,953
Paid related to:			
Current year	232,682	225,713	257,061
Prior years	76,453	74,126	68,068
Total paid	309,135	299,839	325,129
Net balance at December 31	138,986	148,066	166,302
Plus reinsurance recoverables	42,802	53,844	31,364
Balance at December 31	\$181,788	\$201,910	\$197,666

With the benefit of hindsight, including one year of actual development patterns observed during 2006, the Company's 2005 loss reserves were subsequently re-estimated to be \$138.1 million. This produced a net cumulative redundancy,

after one year of development, of \$10.0 million which benefited incurred losses in 2006. Although the 2005 loss reserves developed favorably in 2006, the redundancy was lower than what was experienced over the last few years. The lower redundancy related to the 2005 loss reserves was due primarily to adverse development in 2006 related to assessments associated with hurricane Katrina combined with the Company's personal liability lines and excess and surplus lines of business. The Company continued to see favorable development related to its motorcycle product.

In 2005 and 2004 incurred losses related to prior years benefited from claims settling in 2005 and in 2004 for less than the case base reserve amounts that were estimated at the end of the previous respective years.

	2006	2005	2004
Property and Casualty			
Gross Loss Reserves	\$181,788	\$210,910	\$197,666
Life and Other			
Gross Loss Reserves	19,115	14,378	13,434
Outstanding Checks and Drafts	20,736	38,372	21,815
Consolidated Gross Loss Reserves	\$221,639	\$254,660	\$232,915

Loss reserves, net of reinsurance, for Life and Other totaled \$7.4 million, \$6.0 million and \$6.9 million at December 31, 2006, 2005 and 2004 respectively.

## 12. BENEFIT PLANS

The Company has a qualified defined benefit pension plan which provides for the payment of annual benefits to participants upon retirement. Such benefits are based on years of service and the participant's highest compensation during five consecutive years of employment. The Company's funding policy is to contribute annually an amount sufficient to satisfy ERISA funding requirements. Contributions are intended to provide not only for benefits attributed to service to date but also for benefits expected to be earned in the future. During 2000, the participants of the qualified pension plan were given a one-time election to opt out of the qualified pension plan and enroll in a qualified self-directed defined contribution retirement plan. All employees hired subsequent to that election are automatically enrolled in the qualified self-directed defined contribution retirement plan. The Company contributed \$2.8 million, \$2.3 million and \$1.9 million to the qualified self-directed retirement plan for the years 2006, 2005 and 2004, respectively.

The Company has a qualified 401(k) savings plan, a funded non-qualified savings plan and a funded non-qualified self-directed retirement plan. The Company contributed (amounts in 000's) \$1,412, \$1,256 and \$1,118 to the qualified 401(k) savings plan and \$202, \$250 and \$228 to the non-qualified savings plan for the years 2006, 2005 and 2004, respectively. The Company also has an unfunded non-qualified defined benefit pension plan.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

The Company uses a measurement date of December 31 for its pension plans. The following tables include amounts related to both the qualified and non-qualified defined benefit pension plans (amounts in 000's except for percentages):

	2006	2005
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 30,953	\$ 27,690
Service cost	909	837
Interest cost	1,725	1,648
Actuarial (gain)/loss	(141)	1,772
Benefits paid	(1,034)	(994)
Benefit obligation at end of year (accumulated benefit obligation of \$27,097 and \$26,483, respectively)	<u>\$ 32,412</u>	<u>\$ 30,953</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	\$ 19,741	\$ 18,793
Actual return on plan assets	2,048	731
Employer contributions	1,016	1,211
Benefits paid	(1,034)	(994)
Fair value of plan assets at end of year	<u>\$ 21,771</u>	<u>\$ 19,741</u>
Funded status:		
Funded status at end of year	\$(10,641)	\$(11,211)
Unrecognized net actuarial loss	—	10,170
Unrecognized prior service cost	—	302
Accrued benefit cost	<u>\$(10,641)</u>	<u>\$ (739)</u>

	2006	2005
Amounts recognized in the Consolidated Balance Sheets consist of:		
Prepaid benefit cost	\$ —	\$ —
Accrued benefit cost	(10,641)	(739)
Additional minimum liability	—	(6,018)
Intangible asset	—	302
Accumulated other comprehensive income	—	5,716
Net amount recognized at end of year	<u>\$(10,641)</u>	<u>\$ (739)</u>

	2006	2005	2004
Components of net periodic benefit cost:			
Service cost	\$ 909	\$ 837	\$ 804
Interest cost	1,725	1,648	1,500
Expected return on assets	(1,655)	(1,580)	(1,629)
Amortization of:			
Transition asset	—	—	(72)
Prior service cost	30	30	31
Actuarial loss	477	348	86
Net periodic benefit cost	<u>\$ 1,486</u>	<u>\$ 1,283</u>	<u>\$ 720</u>

At December 31, 2006, the actuarial loss and prior service cost recognized in accumulated other comprehensive income and not yet recognized as a component of net periodic benefit cost consist of (in 000's) \$7,776 and \$262, respectively.

The estimated actuarial loss and prior service cost that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2007 are (in 000's) \$479 and \$30, respectively.

The assumptions used relative to the plans are evaluated annually and updated as necessary. The discount rate assumption is based on average bond yields for high quality corporate bonds. The expected long-term rate of return assumption was based on actuarial recommendations, economic conditions and the historical performance of the plan's investment portfolio over the past ten years.

	2006	2005	2004
Assumptions:			
Weighted average assumptions:			
For disclosure:			
Discount rate	5.90%	5.50%	5.75%
Rate of compensation increase	4.00%	4.00%	4.00%
For measuring net periodic pension benefit cost:			
Discount rate	5.50%	5.75%	6.00%
Rate of compensation increase	4.00%	4.00%	4.00%
Expected return on plan assets	8.00%	8.00%	8.00%

Plan assets consist primarily of equity and fixed income securities managed by non-affiliated professional investment managers. No plan assets are invested in either real estate or the Company's stock. The following table reflects the asset allocations at fair value related to plan assets in 2006 and 2005:

	Weighted average asset allocation	
	2006	2005
Total equity securities	60%	60%
Total fixed income securities	38%	37%
Cash and cash equivalents	2%	3%
Total	<u>100%</u>	<u>100%</u>

The primary objective for the investment of plan assets is the preservation of capital with an emphasis on long-term growth without undue exposure to risk. Targeted allocations are 50% to 80% for equities and 20% to 50% for fixed income securities.

The Company's qualified defined benefit pension plan had projected benefit obligations, accumulated benefit obligations and fair value of plan assets amounting to (in 000's) \$30,726, \$25,334 and \$21,771 in 2006 and \$29,213, \$24,869 and \$19,741 in 2005, respectively. The Company's non-qualified defined benefit plan had projected benefit obligations, accumulated benefit obligations and fair value of plan assets amounting to (in 000's) \$1,686, \$1,763 and \$0 in 2006 and \$1,740, \$1,614 and \$0 in 2005, respectively.

THE MIDLAND COMPANY AND SUBSIDIARIES

The Company made a cash contribution of \$1.0 million in 2006 which exceeded its required cash contribution of \$0.6 million. The Company's expected pension benefit payments, which reflect expected future service, for the next ten years are as follows (amounts in 000's): 2007 — \$1,264; 2008 — \$1,311; 2009 — \$1,364; 2010 — \$1,463; 2011 — \$1,567; 2012 through 2016 — \$10,459.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statement No. 87, 88, 106 and 132(R)" ("SFAS 158"). This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The following table illustrates the incremental effect of applying SFAS 158 on individual line items on the Consolidated Balance Sheet at December 31, 2006 (amounts in 000's):

	Before Application of Statement 158		After Application of Statement 158	
		Adjustments		
Other Assets	\$ 38,498	\$ (272)	\$ 38,226	
Total Assets	1,569,800	(272)	1,569,528	
Liability for				
pension benefits	5,326	5,315	10,641	
Deferred federal				
income tax	49,152	(1,955)	47,197	
Total liabilities	991,422	3,360	994,782	
Accumulated other				
comprehensive				
income	75,978	(3,632)	72,346	
Total shareholder's				
equity	578,378	(3,632)	574,746	

At December 31, 2006 (prior to adoption of SFAS 158) and 2005, the Company's additional minimum pension liabilities were \$4.1 million and \$6.0 million, respectively. Related to these actuarially determined minimum pension liabilities, comprehensive income was increased by \$1.2 million at December 31, 2006, net of deferred federal income taxes and prior to adoption of SFAS 158, and reduced by \$1.6 million, net of deferred federal income taxes, at December 31, 2005.

### 13. STOCK OPTIONS AND AWARD PLANS

Midland's equity compensation plans include plans for restricted stock, performance shares and non-qualified stock options.

The Company implemented a restricted stock award program during 1993. Under this program, restricted grants of the Company's common stock will vest after a five-year incentive period, conditioned upon the recipient's employment throughout the period. During the vesting period, shares issued are nontransferable, but the shares are entitled to all of the other rights of outstanding shares. In 2004, 202,000 shares were distributed relating to the 1999 grant. At December 31, 2006 and 2005, no restricted stock awards were outstanding.

In 2000, the Company established a performance stock award program. Under this program, shares vest after a three-year performance measurement period and will only be awarded if pre-established performance levels have been achieved. Shares

are awarded at no cost and the recipient must have been employed throughout the entire three-year performance period. In 2006, 61,000 shares were issued under this program, 57,000 shares have been earned and are scheduled for distribution in 2007, and a maximum of 60,000 and 82,000 shares could potentially be issued in 2008 and 2009, respectively, related to this program. The expected fair value of these awards is charged to compensation expense over the performance period. Compensation expense for 2006, 2005 and 2004 amounted to (amounts in 000's) \$3,085, \$2,215 and \$1,852, respectively.

Under the Company's stock option plans, all of the outstanding stock options at December 31, 2006 were non-qualified options and had an exercise price of not less than 100% of the fair market value of the common stock on the date of grant. Of these stock options, 990,000 were exercisable at December 31, 2006, and 225,000, 171,000, 121,000 and 75,000 options become exercisable in 2007, 2008, 2009 and 2010, respectively. A summary of stock option transactions follows:

	2006		2005		2004	
	Wtd. Avg. (000's) Option Shares	Price	(000's) Option Shares	Wtd. Avg. (000's) Option Price	(000's) Option Shares	Wtd. Avg. (000's) Option Price
Outstanding, beginning of year	1,426	\$19.98	1,272	\$17.38	1,091	\$15.73
Exercised	(163)	14.86	(61)	12.97	(43)	14.64
Forfeited	(32)	29.08	(3)	24.74	(17)	17.72
Granted	351	32.10	218	33.21	241	24.40
Outstanding, end of year	1,582	\$23.00	1,426	\$19.98	1,272	\$17.38
Exercisable, end of year	990	\$19.00	916	\$16.70	753	\$15.12

Information regarding such outstanding options at December 31, 2006 follows:

Remaining Life	Outstanding Options (000's)	Price
Less than one year	15	\$ 6.32
Two years	38	13.05
Three years	167	11.38
Four years	166	16.59
Five years	171	20.78
Six years	256	17.23
Seven years	226	24.40
Eight years	208	33.21
Nine years	335	32.10
Total outstanding	1,582	
Weighted average price		\$23.00

At December 31, 2006, options exercisable have exercise prices between \$6.32 and \$33.21 and an average contractual life of approximately 5.1 years.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

At December 31, 2006, 978,000 common shares are authorized for future option award or stock grants.

During the fourth quarter of 2005, the Company elected to early adopt SFAS 123 (Revised 2004), "Share-Based Payment" ("SFAS 123(R)") under the modified retrospective approach, restating only prior interim periods in fiscal 2005. The Company recognized \$2.5 million and \$1.9 million of expense in 2006 and 2005, respectively, related to its stock option program.

### 14. EARNINGS PER SHARE

The following table is a reconciliation of the number of shares used to compute Basic and Diluted earnings per share. No adjustments are necessary to the income used in the Basic or Diluted calculations for the years ended December 31, 2006, 2005 or 2004.

	Shares in 000's		
	2006	2005	2004
Shares used in basic			
EPS calculation (average			
shares outstanding)	19,081	18,894	18,618
Effect of dilutive			
stock options	424	385	455
Effect of dilutive			
performance stock awards	153	128	117
Shares used in diluted			
EPS calculation	19,658	19,407	19,190

### 15. COMMITMENTS AND CONTINGENCIES

Various litigation and claims against the Company and its subsidiaries are in process and pending. Based upon a review of open matters with legal counsel, Management believes that the outcome of such matters will not have a material effect upon the Company's consolidated financial position, results of operations or cash flows. The Company also has credit exposure with customers, generally in the form of premiums receivable. Management monitors these exposures on a regular basis. However, as collectibility of such receivables is dependent upon the financial stability of the customers, the Company cannot assure collections in full. Where appropriate, the Company has provided a reserve for such exposures.

### 16. SHAREHOLDERS' EQUITY

The Company has 40,000,000 shares of common stock authorized for issuance without par value (stated value of \$.042 a share). The Company also has 1,000,000 shares of preferred stock authorized, without par value, none of which have been issued.

On February 5, 2004, the Company sold 1,150,000 shares of its common stock pursuant to an approved universal shelf registration statement previously filed with the Securities and Exchange Commission on October 21, 2003. The net proceeds derived from the sale of \$25.1 million were used to increase the capital and paid-in surplus of the Company's insurance subsidiaries to fund future growth and for other general corporate purposes.

In January 2001, the Company's Board of Directors authorized the repurchase of up to 1,000,000 shares of the Company's common stock and 414,000 of these shares have been repurchased as of December 31, 2006. No shares were repurchased under this program in 2006 or 2005.

The change in accumulated other comprehensive income is due to changes related to the unrealized gains and losses on investments, the fair value of interest rate swap, additional minimum pension liability and the adoption of SFAS 158 as follows (amounts in 000's):

	2006	2005	2004
Unrealized holding			
gains (losses) on securities			
arising during the period	\$22,468	\$ (9,807)	\$ 7,421
Impact of net			
realized gain	(8,445)	(6,262)	(9,933)
Income taxes on above	2,876	2,192	3,478
Change in unrealized gains			
(losses) on securities, net	16,899	(13,877)	966
Fair value of interest			
rate swaps	—	432	1,002
Income taxes on above	—	(151)	(351)
Change in interest			
rate swaps, net	—	281	651
Additional Pension Liability	1,871	(2,411)	(3,146)
Income Taxes on above	(655)	843	1,101
Change in additional			
pension liability, net	1,216	(1,568)	(2,045)
SFAS 158 Pension Adjustment	(5,587)	—	—
Income taxes on above	1,955	—	—
Change in funded status, net	(3,632)	—	—
Net increase (decrease)			
in accumulated other			
comprehensive income	\$14,483	\$ (15,164)	\$ (428)

The insurance subsidiaries are subject to state regulations which limit by reference to statutory net income and policyholders' surplus the dividends that can be paid to their parent company without prior regulatory approval. Dividend restrictions vary between the companies as determined by the laws of the domiciliary states. Under these restrictions, the maximum dividends that may be paid by the insurance subsidiaries in 2007 without regulatory approval total (amounts in 000's): \$65,533; such subsidiaries paid cash dividends of \$13,835 in 2006, \$23,030 in 2005 and \$2,600 in 2004.

Net income as reported by the Company's insurance subsidiaries, determined in accordance with statutory accounting practices, which differ in certain respects from accounting principles generally accepted in the United States of America, for the Company's insurance subsidiaries was (amounts in 000's): \$64,053, \$68,634 and \$57,677 for 2006, 2005 and 2004, respectively. Statutory surplus as reported by the Company's insurance subsidiaries, was (amounts in 000's): \$450,729 and \$394,314 at December 31, 2006 and 2005, respectively.

## 17. RELATED PARTY TRANSACTIONS

The Company has a commercial paper program under which qualified purchasers may invest in the short-term unsecured notes of Midland. Many of the investors in this program are executive officers and directors of the Company. Total commercial paper debt outstanding at December 31, 2006 and 2005 was \$7.9 million and \$6.0 million, respectively, of which \$6.6 million and \$5.1 million at those respective dates represented notes held either directly or indirectly by the executive officers and directors of the Company. The effective annual yield paid to all participants in this program was 5.4% as of December 31, 2006, a rate that is considered to be competitive with the market rate for similar instruments.

## 18. INDUSTRY SEGMENTS

The Company operates in several industries and Company management reviews operating results by several different classifications (e.g., product line, legal entity, distribution channel). Reportable segments are determined based upon revenues and/or operating profits and are based on significant product groups, which include residential property, recreational casualty, financial institutions, all other insurance and transportation.

The residential property segment includes primarily manufactured housing and site-built dwelling insurance products. Approximately 41% of American Modern's property and casualty and credit life gross written premium relates to physical damage insurance and related coverages on manufactured homes, generally written for a term of 12 months with many coverages similar to homeowner's insurance policies. The recreational casualty segment includes specialty insurance products such as motorcycle, watercraft, recreational vehicle, collector car and snowmobile. The financial institutions segment includes specialty insurance products such as mortgage fire, collateral protection and debt cancellation, which are sold to financial institutions or their customers. The all other insurance segment includes products such as credit life, long-haul truck physical damage, commercial, excess and surplus lines and also includes the results of our fee producing subsidiaries.

The Company writes insurance throughout the United States with larger concentrations in the southern and southeastern states. Transportation includes barge chartering and freight brokerage operations primarily on the lower Mississippi River and its tributaries.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### THE MIDLAND COMPANY AND SUBSIDIARIES

Listed below is financial information required to be reported for each industry segment. The accounting policies used for segment reporting are the same as the accounting policies for the consolidated financial statements. Certain amounts are allocated and certain amounts are not allocated (e.g., assets and investment gains) to each segment for management review. Operating segment information based upon how it is reviewed by the chief operating decision maker, the Company's President and Chief Executive Officer, is as follows for the years ended December 31, 2006, 2005 and 2004 (amounts in 000's):

	Insurance Group				Unallocated Insurance Amounts	Transportation	Corporate and All Other	Intersegment Elimination	Total
	Residential Property	Recreational Casualty	Financial Institutions	All Other Insurance					
<b>2006</b>									
Revenues—External customers	\$398,886	\$ 97,271	\$103,831	\$ 88,681		\$49,807	\$ 124		\$ 738,600
Net investment income	21,376	5,614	5,106	8,310	\$ 342		2,899	\$ (1,424)	42,223
Net realized investment gains					8,445				8,445
Interest expense					1,130	945	5,055	(1,966)	5,164
Depreciation and amortization	3,419	1,357	378	960		2,429	850		9,393
Income before taxes	42,554	10,186	12,507	26,751	7,715	7,842	(9,701)		97,854
Income tax expense					28,684	2,734	(4,259)		27,159
Acquisition of fixed assets					16,802	17,374	16,656		50,832
Identifiable assets					1,419,716	51,435	111,732	(13,355)	1,569,528
<b>2005</b>									
Revenues—External customers	\$384,053	\$105,607	\$78,424	\$76,414		\$42,185	\$ (34)		\$ 686,649
Net investment income	20,682	6,000	4,194	7,627	\$ 216		2,544	\$ (744)	40,519
Net realized investment gains					6,262				6,262
Interest expense					1,737	761	4,375	(906)	5,967
Depreciation and amortization	3,903	1,501	419	939		2,923	836		10,521
Income before taxes	45,755	12,693	9,471	19,903	5,877	4,886	(5,684)		92,901
Income tax expense					28,159	1,720	(2,304)		27,575
Acquisition of fixed assets					18,085	13,172	1,178		32,435
Identifiable assets					1,295,938	50,400	102,859	(21,084)	1,428,113
<b>2004</b>									
Revenues—External customers	\$406,544	\$121,432	\$86,803	\$76,405		\$45,379	\$ 180		\$ 736,743
Net investment income	19,120	6,107	3,615	6,902	\$ 172		1,546	\$ (297)	37,165
Net realized investment gains					19,623		43	(9,733)	9,933
Interest expense					2,038	856	2,730	(455)	5,169
Depreciation and amortization	4,238	1,836	275	570		2,296	1,652		10,867
Income before taxes	47,418	4,987	6,991	12,396	17,816	1,689	(4,460)	(9,733)	77,104
Income tax expense					27,662	599	(1,989)	(3,406)	22,866
Acquisition of fixed assets					9,392	2,160	147		11,699
Identifiable assets					1,248,521	38,869	113,716	(36,422)	1,364,684

The amounts shown for residential property, recreational casualty, financial institutions, all other insurance and unallocated insurance comprise the consolidated amounts for Midland's insurance operations subsidiary, American Modern Insurance Group, Inc. Intersegment revenues were not significant for 2006, 2005 or 2004. During 2004 the Midland parent company purchased 492,634 shares of U.S. Bancorp common stock from American Modern Insurance Group, Inc. The effects of this transaction were eliminated from consolidated net realized investment gains, income before taxes and income tax expense.

Revenues reported above, by definition, exclude investment income and realized gains. For income before taxes reported above, insurance investment income is allocated to the insurance segments while realized gains and losses are included in Unallocated Insurance Amounts. The Company allocates insurance investment income to the segments based primarily on written premium volume. The Company does not allocate realized gains or losses to the segments as the Company evaluates the performance of the segments exclusive of the impact of realized gains or losses due to potential timing issues. Certain other amounts are also not allocated to segments by the Company.

No single customer contributed in excess of 10% of consolidated revenues in 2006, 2005 or 2004.

## QUARTERLY DATA (UNAUDITED)

THE MIDLAND COMPANY AND SUBSIDIARIES

<i>(Amounts in thousands, except per share data)</i>	2006				2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	\$186,932	\$190,173	\$204,813	\$207,350	\$190,366	\$186,338	\$173,243	\$183,483
Net income	\$ 22,435	\$ 9,805	\$ 17,345	\$ 21,110	\$ 21,144	\$ 20,450	\$ 3,732	\$ 20,000
Basic earnings per common share <sup>(a)</sup>	\$ 1.18	\$ 0.51	\$ 0.91	\$ 1.10	\$ 1.12	\$ 1.08	\$ 0.20	\$ 1.06
Diluted earnings per common share <sup>(a)</sup>	\$ 1.15	\$ 0.50	\$ 0.88	\$ 1.07	\$ 1.08	\$ 1.05	\$ 0.19	\$ 1.03
Dividends per common share	\$0.06125	\$0.06125	\$0.06125	\$0.06125	\$0.05625	\$0.05625	\$0.05625	\$0.05625
Price range of common stock (Nasdaq):								
High	\$ 37.75	\$ 44.10	\$ 43.75	\$ 47.50	\$ 34.63	\$ 35.32	\$ 40.42	\$ 39.45
Low	\$ 31.91	\$ 32.50	\$ 34.86	\$ 39.84	\$ 29.55	\$ 30.60	\$ 31.38	\$ 31.13

(a) The sum of quarterly earnings per common share may not equal the year end earnings per common share due to rounding.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE MIDLAND COMPANY AND SUBSIDIARIES

# Deloitte.

To the Shareholders and Board of Directors of  
The Midland Company:

We have audited the accompanying consolidated balance sheets of The Midland Company and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Midland

Company and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the Company adopted the recognition and related disclosure provisions of Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R), on December 31, 2006 and Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, on January 1, 2005.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 7, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

*Deloitte & Touche LLP*

Cincinnati, Ohio  
March 7, 2007

## MANAGEMENT'S ASSESSMENT AS TO THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of The Midland Company is responsible for establishing and maintaining adequate internal control, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention of overriding controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

The Company's Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 as required by Section 404 of the Sarbanes Oxley Act of 2002. Management's assessment is based on the criteria established in the Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and was designed to provide reasonable assurance that the Company maintained effective internal control over financial reporting as of December 31, 2006. Based on our assessment, we believe that the Company maintained effective internal control over financial reporting as of December 31, 2006.

The Company's independent registered public accounting firm has issued an attestation report on our internal control over financial reporting as of December 31, 2006 and the Company's management assessment of the internal control over financial reporting. This report appears on page 61.

John W. Hayden  
President and  
Chief Executive Officer

W. Todd Gray  
Executive Vice President and  
Chief Financial Officer

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE MIDLAND COMPANY AND SUBSIDIARIES

# Deloitte.

To the Shareholders and Board of Directors of  
The Midland Company:

We have audited management's assessment, included in the accompanying Management's Assessment as to the Effectiveness of Internal Control Over Financial Reporting, that The Midland Company and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the

company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006 of the Company and our report dated March 7, 2007 (which includes an explanatory paragraph related to Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R), on December 31, 2006 and Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, on January 1, 2005) expressed an unqualified opinion on those financial statements.

*Deloitte & Touche LLP*

Cincinnati, Ohio  
March 7, 2007

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## OTHER INFORMATION

THE MIDLAND COMPANY AND SUBSIDIARIES

### **TRANSFER AGENT AND REGISTRAR**

National City Bank  
Shareholder Services  
P.O. Box 92301  
Cleveland, Ohio 44193-0900  
1-800-622-6757  
[shareholder.inquiries@nationalcity.com](mailto:shareholder.inquiries@nationalcity.com)  
or  
<http://www.nationalcitystocktransfer.com>

### **INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Deloitte & Touche LLP  
250 East Fifth Street  
Cincinnati, Ohio 45202

### **SHAREHOLDERS' MEETING**

The next meeting of the shareholders will be held at 8:30 a.m. on Thursday, April 26, 2007 at the Company's offices, 7000 Midland Boulevard, Amelia, Ohio 45102.

### **MARKET FOR REGISTRANT'S COMMON STOCK**

The Midland Company Common Stock is traded on the NASDAQ National Market System. The symbol is MLAN.

### **DIVIDEND REINVESTMENT PLAN**

The Plan provides for the acquisition of additional shares of the Company without brokerage fees through automatic dividend reinvestment. Enrollment forms and information about the Plan are available from National City Bank (1-800-622-6757).

### **FORM 10-K**

A copy of the Company's 2006 Annual Report to the Securities and Exchange Commission on Form 10-K may be obtained free of charge by writing to the Company – Attention: Chief Financial Officer or from the Company's website [www.midlandcompany.com](http://www.midlandcompany.com).

### **FINANCIAL INFORMATION**

For financial information visit us on the internet at [www.nasdaq.com](http://www.nasdaq.com) or [www.midlandcompany.com](http://www.midlandcompany.com)

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## DIRECTORS AND OFFICERS

THE MIDLAND COMPANY AND SUBSIDIARIES

### BOARD OF DIRECTORS

**James E. Bushman** (a) (b) (c)  
President and Chief Executive Officer  
Cast-Fab Technologies, Inc.

**James H. Carey** (a) (b) (d)  
Corporate Director/Advisor

**Michael J. Conaton** (c)  
Former President and Vice Chairman of the Company

**Jerry A. Grundhofer** (e)  
Chairman and Former Chief Executive Officer  
US Bancorp

**J. P. Hayden, Jr.** (c)  
Chairman of the Executive Committee of the Board,  
Former Chairman and Chief Executive Officer  
of the Company

**J. P. Hayden III** (c) (e)  
Chairman and Chief Operating Officer

**John W. Hayden** (c) (e)  
President and Chief Executive Officer

**William T. Hayden**  
Partner – Katz, Teller, Brant & Hild LPA

**William J. Keating, Jr.** (b) (d) (e)  
Partner – Keating, Muething & Klekamp PLL

**John R. LaBar**  
Former Vice President and Secretary of the Company

**Richard M. Norman** (a)  
Senior Vice President for Finance and Business Services  
and Treasurer of Miami University, Ohio

**David B. O'Maley** (e)  
Chairman, President and Chief Executive Officer  
Ohio National Financial Services

**John M. O'Mara** (b) (c) (d)  
Corporate Director/Financial Consultant

**René J. Robichaud** (e)  
Former President and Chief Executive Officer  
NS Group, Inc.

**Francis Marie Thraikill, OSU Ed.D.** (d)  
President College of Mount St. Joseph

**John I. Von Lehman** (e)  
Executive Vice President and Secretary

- (a) Member of Audit Committee
- (b) Member of Compensation Committee
- (c) Member of Executive Committee
- (d) Member of Governance and Nominating Committee
- (e) Member of Opportunities Committee

### OFFICERS

**J. P. Hayden III**  
Chairman and Chief Operating Officer

**John W. Hayden**  
President and Chief Executive Officer

**John I. Von Lehman**  
Executive Vice President and Secretary

**Paul F. Gelter**  
Executive Vice President

**W. Todd Gray**  
Executive Vice President and  
Chief Financial Officer

**Elisabeth E. Baldock**  
Vice President – Human Resources/  
Learning and Development

**Michael L. Flowers**  
Vice President and Assistant Secretary

**Mark E. Burke**  
Director of Taxation

**James E. Kroeger**  
Director of Internal Audit

**Alisa E. Poe**  
Vice President

**Matthew J. McConnell**  
Treasurer

**Anthony W. Dirksing**  
Controller

**Ronald L. Gramke**  
Assistant Treasurer

**Edward J. Heskamp**  
Assistant Treasurer

**James E. Hinkle**  
Assistant Treasurer

**Mary Ann C. Pettit**  
Assistant Secretary

**Jennifer W. Colvin**  
Assistant Secretary



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