

UNITED FIRE & CASUALTY CO
Form 10-Q
October 30, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended September 30, 2006

Commission File Number 2-39621

UNITED FIRE & CASUALTY COMPANY

(Exact name of registrant as specified in its charter)

Iowa
(State of Incorporation)

42-0644327
(IRS Employer Identification No.)

118 Second Avenue, S.E., Cedar Rapids, Iowa 52407

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (319) 399-5700

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

YES ☒ NO ☐

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

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Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b2 of the Act).

YES ☐ NO ☒

As of October 26, 2006, 27,633,153 shares of common stock were outstanding.

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FORWARD-LOOKING INFORMATION

It is important to note that our actual results could differ materially from those projected in our forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in Part I Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations and Part II, Item 1A Risk Factors.

PART I: FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****Consolidated Balance Sheets****United Fire & Casualty Company and Subsidiaries**

(Dollars in Thousands Except Per Share Data)

	September 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Investments		
Fixed maturities		
Held-to-maturity, at amortized cost (fair value \$53,012 in 2006 and \$75,222 in 2005)	\$ 51,750	\$ 72,765
Available-for-sale, at fair value (amortized cost \$1,779,345 in 2006 and \$1,739,483 in 2005)	1,802,689	1,777,111
Equity securities, at fair value (cost \$64,329 in 2006 and \$49,839 in 2005)	184,701	158,522
Trading securities, at fair value (amortized cost \$8,853 in 2006 and \$4,898 in 2005)	9,784	4,881
Mortgage loans	28,265	23,637
Policy loans	8,104	8,193
Other long-term investments	11,095	11,036
Short-term investments	44,956	35,485
	\$ 2,141,344	\$ 2,091,630
Cash and Cash Equivalents	\$ 237,031	\$ 162,791
Accrued Investment Income	28,462	30,232
Premiums Receivable	137,304	115,655
Deferred Policy Acquisition Costs	133,118	119,869
Property and Equipment (primarily land and buildings, at cost, less accumulated depreciation of \$27,904 in 2006 and \$25,722 in 2005)	10,699	11,150
Reinsurance Receivables and Recoverables	60,438	126,161
Prepaid Reinsurance Premiums	6,062	3,015
Income Taxes Receivable	6,719	40,689
Other Assets	22,746	20,732
TOTAL ASSETS	\$ 2,783,923	\$ 2,721,924
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Future policy benefits and losses, claims and loss settlement expenses		
Property and casualty insurance	\$ 521,887	\$ 620,100
Life insurance	1,243,899	1,285,635
Unearned premiums	244,227	222,267
Accrued expenses and other liabilities	70,357	57,558
Deferred income taxes	42,032	36,152
TOTAL LIABILITIES	\$ 2,122,402	\$ 2,221,712
Stockholders' Equity		
Common stock, \$3.33 1/3 par value; authorized 75,000,000 shares; 27,633,153 shares issued and outstanding in 2006 and 23,597,773 shares issued and outstanding in 2005	\$ 92,108	\$ 78,658
Additional paid-in capital	160,809	66,242
Retained earnings	318,227	268,872
Accumulated other comprehensive income, net of tax	90,377	86,440
TOTAL STOCKHOLDERS' EQUITY	\$ 661,521	\$ 500,212
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 2,783,923	\$ 2,721,924

The Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

Consolidated Statements of Income (Unaudited)**United Fire & Casualty Company and Subsidiaries**(Dollars in Thousands Except Per Share Data)
Ended September 30,

	Three Months		Nine Months	
	2006	2005	2006	2005
Revenues				
Net premiums earned	\$ 126,849	\$ 119,238	\$ 370,125	\$ 366,443
Investment income, net	30,896	29,804	90,365	87,830
Realized investment gains	301	631	8,240	4,065
Other income	131	150	476	481
	\$ 158,177	\$ 149,823	\$ 469,206	\$ 458,819
Benefits, Losses and Expenses				
Losses and loss settlement expenses	\$ 71,346	\$ 82,708	\$ 223,860	\$ 193,708
Increase in liability for future policy benefits	4,367	4,249	13,586	12,498
Amortization of deferred policy acquisition costs	31,910	27,697	92,445	83,445
Other underwriting expenses	5,484	11,287	19,495	30,463
Interest on policyholders' accounts	12,082	13,565	37,554	41,425
	\$ 125,189	\$ 139,506	\$ 386,940	\$ 361,539
Income before income taxes	\$ 32,988	\$ 10,317	\$ 82,266	\$ 97,280
Federal income tax expense	10,562	2,362	23,447	29,808
Net income	\$ 22,426	\$ 7,955	\$ 58,819	\$ 67,472
Less preferred stock dividends and accretions				4,106
Earnings available to common shareholders	\$ 22,426	\$ 7,955	\$ 58,819	\$ 63,366
Weighted average common shares outstanding	27,633,153	23,595,653	25,624,094	22,056,455
Basic earnings per common share	\$ 0.81	\$ 0.34	\$ 2.30	\$ 2.87
Diluted earnings per common share	\$ 0.81	\$ 0.34	\$ 2.29	\$ 2.85
Cash dividends declared per common share	\$ 0.12	\$ 0.12	\$ 0.36	\$ 0.36

The Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

Consolidated Statements of Cash Flows (Unaudited)

United Fire & Casualty Company and Subsidiaries

(Dollars in Thousands)		
Ended September 30,		
	Nine Months	
	2006	2005
Cash Flows From Operating Activities		
Net income	\$58,819	\$ 67,472
Adjustments to reconcile net income to net cash provided by operating activities:		
Net bond premium accretion	\$ 1,482	\$ 493
Depreciation and amortization	2,721	2,757
Realized investment gains	(8,240))	(4,065))
Net cash flows from trading investments	(4,663))	3,672
Deferred income tax expense	4,618	656
Changes in:		
Accrued investment income	1,770	(3,019))
Premiums receivable	(21,649))	(9,261))
Deferred policy acquisition costs	(4,679))	(532))
Reinsurance receivables	65,723	(106,728))
Prepaid reinsurance premiums	(3,047))	22
Income taxes receivable/payable	33,970	(8,442))
Other assets	(2,014))	(3,814))
Future policy benefits and losses, claims and loss settlement expenses	(77,942))	144,499
Unearned premiums	21,960	4,805
Accrued expenses and other liabilities	12,799	5,304
Deferred income taxes	(856))	(309))
Other, net	414	852
Total adjustments	\$22,367	\$ 26,890
Net cash provided by operating activities	\$81,186	\$ 94,362
Cash Flows From Investing Activities		
Proceeds from sale of available-for-sale investments	\$ 754	\$ 3,929
Proceeds from call and maturity of held-to-maturity investments	21,348	10,510
Proceeds from call and maturity of available-for-sale investments	175,783	154,689
Proceeds from short-term and other investments	36,062	37,131
Purchase of available-for-sale investments	(224,387))	(342,298))
Purchase of short-term and other investments	(49,932))	(19,248))
Net purchases and sales of property and equipment	(2,229))	(1,354))
Net cash used in investing activities	\$(42,601))	\$ (156,641))
Cash Flows From Financing Activities		
Policyholders' account balances:		
Deposits to investment and universal life contracts	\$ 139,824	\$ 92,157
Withdrawals from investment and universal life contracts	(201,831))	(87,004))
Issuance of common stock	107,126	699
Redemption of preferred stock		(142))
Payment of cash dividends	(9,464))	(9,181))
Net cash provided (used) by financing activities	\$35,655	\$ (3,471))
Net Change in Cash and Cash Equivalents	\$74,240	\$ (65,750))
Cash and Cash Equivalents at Beginning of Period	162,791	305,575
Cash and Cash Equivalents at End of Period	\$237,031	\$ 239,825

The Notes to Unaudited Consolidated Financial Statements are an integral part of these statements.

Notes to Unaudited Consolidated Financial Statements

United Fire & Casualty Company and Subsidiaries

Basis of Presentation

The terms United Fire, we, us, or our refer to United Fire & Casualty Company or United Fire & Casualty Company and its consolidated subsidiaries and affiliate, as the context requires. In the opinion of the management of United Fire, the accompanying unaudited Consolidated Financial Statements contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position, the results of operations and cash flows for the periods presented. The results for the interim periods are not necessarily indicative of the results of operations that may be expected for the year. The Consolidated Financial Statements contained herein should be read in conjunction with our annual report on Form 10-K for the year ended December 31, 2005. The review report of Ernst & Young LLP as of and for the three- and nine-month periods ending September 30, 2006 accompanies the unaudited Consolidated Financial Statements included in Item 1 of Part I.

We maintain our records in conformity with the accounting practices prescribed or permitted by the insurance departments of the states in which we are domiciled. To the extent that certain of these practices differ from U.S. generally accepted accounting principles (GAAP), we have made adjustments to present the accompanying Consolidated Financial Statements in conformity with GAAP.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The financial statement categories that are most dependent on management estimates and assumptions include the valuation of investments, the valuation of reserves for losses, claims and loss settlement expenses, the valuation of reserves for future policy benefits, the calculation of the deferred policy acquisition cost asset, and the valuation of pension and post-retirement benefit obligations.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash, money market accounts and non-negotiable certificates of deposit with original maturities of three months or less. We made payments for income taxes of \$13.5 million for the nine-month period ended September 30, 2006, compared to \$37.9 million for the nine-month period ended September 30, 2005. We have also received tax refunds totaling \$27.8 million through the nine-month period ended September 30, 2006, due to an overpayment of a prior year tax and a capital loss carryback. We made no significant payments of interest for the nine-month periods ended September 30, 2006 and 2005, other than interest credited to policyholders' accounts.

Income Taxes

In the third quarter of 2006, our effective federal income tax rate was 32.0 percent, compared to 22.9 percent for the third quarter of 2005. Our effective tax rate differs from the federal statutory rate of 35.0 percent due principally to the effect of tax-exempt municipal bond interest income, non-taxable dividend income, and the reduction in the valuation allowance on our deferred tax assets.

Contingent Liabilities

In the aftermath of Hurricane Katrina, our Louisiana property and casualty insurance subsidiary, Lafayette Insurance Company, and many other insurers in the Louisiana market have been named defendants in litigation commenced by policyholders seeking class certification alleging various improprieties in the claims settlement process. This litigation is in the very early stages and we cannot at this time make a determination that the litigation is or will be material, but we believe the claims have been handled consistent with the policy language and the applicable law. However, this litigation and the number of potential members of any class certified, could potentially create a

material obligation for Lafayette Insurance Company, although we do not consider this to be a material exposure at this time.

Lafayette Insurance Company and United Fire & Casualty Company have specifically been named as a defendant in approximately 200 lawsuits filed by individual policyholders alleging a right to recover additional money as a result of property damage sustained during Hurricane Katrina and its aftermath. We do not consider the exposure from these lawsuits, individually or in the aggregate, to be material at this time.

We consider all of our other litigation pending at September 30, 2006, to be ordinary, routine and incidental to our business.

Recently Issued Accounting Standards

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as the derecognition of a tax position previously recognized in the financial statements. FIN 48 also prescribes expanded disclosure requirements for unrecognized tax benefits recorded. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently reviewing FIN 48 to determine its impact on our Consolidated Financial Statements upon adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements regarding fair value measurement. Where applicable, FAS 157 simplifies and codifies fair value related guidance previously issued within GAAP. Although FAS 157 does not require any new fair value measurements, its application may, in certain instances, change current practice. FAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently reviewing FAS 157 to determine its impact on our Consolidated Financial Statements upon adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans (FAS 158). FAS 158 requires the recognition of pension and other post-retirement benefit plans' overfunded or underfunded status as an asset or liability on the balance sheet with changes occurring during the current year reflected through the comprehensive income portion of equity, net of tax. However, FAS 158 does not change the amount of net periodic benefit cost recognized as a component of current period of operations. FAS 158 will also require the measurement of the funded status of a plan to match that of the date of our year-end Consolidated Financial Statements, eliminating the use of earlier measurement dates that were previously permissible. The requirement to recognize the funded status of a plan is effective for fiscal years ending after December 15, 2006; the requirement for congruent measurement dates is effective for fiscal years ending after December 15, 2008. We currently utilize December 31 as the measurement date for plan assets and obligations and, therefore, comply with this requirement. We are currently reviewing the other requirements of FAS 158 to determine its impact on our Consolidated Financial Statements upon adoption.

We have a nonqualified employee stock option plan that authorizes the issuance of up to 1,000,000 shares of United Fire common stock to employees. The plan is administered by the Board of Directors. The Board has the authority to determine which employees will receive options, when options will be granted, and the terms and conditions of the options. The Board may also take any action it deems necessary and appropriate for the administration of the plan. Pursuant to the plan, the Board may, at its sole discretion, grant options to any employees of United Fire or any of its affiliated companies. These options are granted to buy shares of United Fire's common stock at the market value of the stock on the date of grant. The options vest and are exercisable in installments of 20 percent of the number of shares covered by the option award each year from the grant date. To the extent not exercised, installments accumulate and are exercisable by the optionee, in whole or in part, in any subsequent year included in the option period, but not later than 10 years from the grant date. Stock options are generally granted free of charge to the eligible employees of United Fire as designated by the Board of Directors. Since the inception of the plan, we have

granted options for 588,792 shares of United Fire common stock pursuant to this plan, of which 113,742 have been exercised and 15,800 have been forfeited. For the nine-month period ended September 30, 2006, we have granted options for 126,750 shares of United Fire common stock pursuant to this plan. During the year, 9,680 options have been exercised and 10,100 options have been forfeited.

We also have a nonqualified nonemployee director stock option and restricted stock plan that authorizes United Fire to grant restricted stock and nonqualified stock options to purchase up to 150,000 shares of United Fire's common stock. The Board has the authority to determine which directors receive options, when options and restricted stock shall be granted, the option price, the option expiration date, the date of grant, the vesting schedule of options or whether the options shall be immediately vested, the terms and conditions of options and restricted stock, other than those terms and conditions set forth in the plan, and the number of shares of common stock to be issued pursuant to an option agreement or restricted stock agreement. The Board may also take any action it deems necessary and appropriate for the administration of the plan. Through September 30, 2006, we have granted 18,000 options pursuant to this plan, none of which have been exercised or forfeited.

Pursuant to our January 1, 2006 adoption of Statement of Financial Accounting Standards (SFAS) No. 123(R) Share-Based Payment, we now recognize stock-based compensation expense on options granted under our stock option plans. This expense is based on the fair value of the respective stock award and is recognized ratably over the underlying vesting period. We utilized the modified-prospective method prescribed by SFAS 123(R) in transitioning to this new accounting treatment for stock-based compensation expense. This method requires that stock-based compensation expense be recorded for all stock options granted subsequent to January 1, 2006 and all unvested stock options that existed upon the adoption of SFAS 123(R). As allowed by SFAS 123(R), we have utilized the Black-Scholes option pricing method to establish the fair value of options granted under our stock option plans. Our determination of fair value of stock-based payment awards on the date of grant using this option-pricing model is affected by our stock price, as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected volatility in our stock price and expected dividends to be paid over the term of the awards, the risk-free interest rate, and actual and projected employee stock option exercise activity. Any changes in these assumptions may materially affect the estimated fair value of the equity-based award.

Prior to the adoption of SFAS 123(R), we presented the tax benefit of stock option exercises as an operating cash flow. Upon the adoption of SFAS 123(R), tax benefits resulting from tax deductions in excess of compensation cost recognized for those options are classified as financing cash flows. This change in presentation did not have a material impact on the amounts reported in the accompanying statement of cash flows for the nine-months ended September 30, 2006.

For the three- and nine-month periods ended September 30, 2006, we recognized stock-based compensation expense under SFAS 123(R) of \$.3 million and \$.8 million, respectively, which resulted in a \$.01 and \$.02 decrease in our basic and diluted earnings per share for each period, respectively. As of September 30, 2006, we have approximately \$3.7 million in stock-based compensation that has yet to be recognized through our results of operations pursuant to SFAS 123(R). This compensation will be reflected through our financial results as the underlying stock options vest. Prior to January 1, 2006, the reporting of pro forma stock-based compensation was limited to disclosure in the notes to the Consolidated Financial Statements. Pro forma net income was \$7.8 million and \$67.2 million for the three- and nine-month periods ended September 30, 2005, respectively. These amounts include \$.1 million and \$.3 million in pro forma stock-based compensation expense (net of the related tax effects) for the three- and nine-month periods ended September 30, 2005, respectively.

Among the employee benefit plans we offer, the two most significant plans are a noncontributory defined benefit pension plan and an employee/retiree health and dental benefit plan.

All of our employees are eligible to participate in the noncontributory defined benefit pension plan after they have completed one year of service, attained 21 years of age, and met the hourly service requirements with United Fire. Under our pension plan, retirement benefits are a function of the number of years of service and the level of compensation. Our policy is to fund this plan on a current basis to the extent that the contribution is deductible under existing tax regulations.

All of our eligible employees and retirees are able to participate in our health and dental benefit plan. The plan is composed of two programs: (1) the Self-Funded Retiree Health and Dental Benefit Plan and (2) the Self-Funded Employee Health and Dental Benefit Plan. The plan provides health and dental benefits to our employees and retirees (and covered dependents) who have met the service and participation requirements stipulated by the plan. The plan's contract administrators are responsible for making medical and dental care benefit payments. The plan requires participants to submit claims for reimbursement or payment to the claims administrator within 365 days after the end of the calendar year in which the charges were incurred. Our pension and post-retirement benefit costs are displayed in the following table.

(Dollars in Thousands) Ended September 30,	Three Months 2006	2005	Nine Months 2006	2005
Pension Costs	\$ 639	\$ 441	\$ 1,918	\$ 1,744
Other Post-retirement Benefit Costs	366	239	1,097	1,012

We previously disclosed in our annual report on Form 10-K for the year ended December 31, 2005 that we expected to contribute \$4.0 million to our pension plan in 2006. For the nine-month period ended September 30, 2006, we have contributed \$4.7 million to the pension plan. We now anticipate that the total contribution in 2006 will be approximately \$5.6 million.

We have two reportable business segments in our operations: property and casualty insurance and life insurance. The property and casualty insurance segment has three domestic locations from which it conducts its business. All offices target a similar customer base, market the same products, and use the same marketing strategies, and are therefore aggregated. The life insurance segment operates from our home office in Cedar Rapids, Iowa. Because all of our insurance is sold domestically, we have no revenues allocable to foreign operations. Our management evaluates the two segments on the basis of both statutory accounting practices prescribed by our states of domicile and GAAP. We analyze results based on profitability (i.e., loss ratios), expenses, and return on equity. The basis we use to determine and analyze segments and to measure segment profit have not changed from that reported in our annual report on Form 10-K for the year ended December 31, 2005.

In May 2006, we closed on the sale of our subsidiary, American Indemnity Company, a Texas domiciled property and casualty insurance company that is licensed in 26 states and the District of Columbia. The sale involved only American Indemnity Company and did not affect the business of any of our other Texas subsidiaries or operations at our Gulf Coast Regional Office in Galveston, Texas. American Indemnity Company had not written or renewed any policies of insurance since November 2003 and was sold as a shell company with no liabilities and only the capital assets necessary to maintain its licenses. The sale of American Indemnity Company resulted in a realized gain of \$3.4 million, which has been recorded in the nine-month results of our property and casualty insurance segment.

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The following analysis has been reconciled to amounts reported in our unaudited Consolidated Financial Statements to adjust for inter-segment eliminations.

(Dollars In Thousands)	Property and Casualty Insurance	Life Insurance	Total
<u>Nine Months Ended September 30, 2006</u>			
Net premiums earned	\$ 343,022	\$27,287	\$370,309
Investment income, net of investment expenses	29,372	61,006	90,378
Realized investment gains	6,570	1,672	8,242
Other income	(45) 521	476
Revenues	\$ 378,919	\$90,486	\$469,405
Inter-segment Eliminations	(100) (99) (199
Total Revenues	\$ 378,819	\$90,387	\$469,206
Net Income	\$ 49,858	\$8,961	\$58,819
Assets	\$ 1,291,307	\$1,492,616	\$2,783,923
<u>Nine Months Ended September 30, 2005</u>			
Net premiums earned	\$ 338,043	\$28,577	\$366,620
Investment income, net of investment expenses	25,747	61,990	87,737
Realized investment gains	2,440	1,625	4,065
Other income		481	481
Revenues	\$ 366,230	\$92,673	\$458,903
Inter-segment Eliminations	(99) 15	(84
Total Revenues	\$ 366,131	\$92,688	\$458,819
Net Income	\$ 60,281	\$7,191	\$67,472
Assets	\$ 1,234,388	\$1,531,175	