REX STORES CORP
Form 8-K
February 21, 2008

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

# FORM 8-K
# CURRENT REPORT

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

Date of Report (Date of earliest event reported): February 21, 2008

REX STORES CORPORATION
(Exact name of registrant as specified in its charter)

| | | |
|---|---|---|
| Delaware | 001-09097 | 31-1095548 |
| (State or other jurisdiction of incorporation) | (Commission File No.) | (IRS Employer Identification No.) |

| | |
|---|---|
| 2875 Needmore Road, Dayton, Ohio | 45414 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (937) 276-3931

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

[ ] Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

[ ] Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a -12)

[ ] Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d -2(b))

[ ] Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e -4(c))

Item 8.01 Other Events.

On February 20, 2008, REX Stores Corporation (the Company), through a wholly owned subsidiary, purchased a $5.0 million secured promissory note from Levelland/Hockley County Ethanol, LLC (Levelland/Hockley). The note provides the Company rights to convert the note into an equity ownership position. With the purchase of this note, REX has no further commitments to provide additional debt or equity financing for Levelland/Hockley.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

REX STORES CORPORATION

Date: February 21, 2008

By: /s/ DOUGLAS L. BRUGGEMAN

Name: Douglas L. Bruggeman
Title: Vice President-Finance,
Chief Financial Officer and
Treasurer

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" ALIGN="center" STYLE="border-bottom:1px solid #000000">**Total Within 1 year 1-3 years 4-5 years After 5 years (Amounts in thousands)**

| (Amounts in thousands) | Total | Within 1 year | 1-3 years | 4-5 years | After 5 years |
|---|---|---|---|---|---|
| Debt (including interest) | $162,324 | $9,063 | $22,625 | $130,636 | $ |
| Lease obligations | 33,170 | 9,890 | 18,770 | 4,510 | |
| Losses and loss adjustment expenses | 1,103,915 | 710,373 | 356,425 | 36,542 | 575 |
| Total Contractual Obligations | $1,299,409 | $729,326 | $397,820 | $171,688 | $575 |

Notes to Contractual Obligations Table:

The amount of interest included in the Company  s debt obligations was calculated using the fixed rate of 7.25% on the senior notes. The Company is party to an interest rate swap of its fixed rate obligations on its senior notes for a floating rate of six month LIBOR plus 107 basis points. Using the effective annual interest rate of 6.4% in 2007, the total contractual obligations on debt would be $158 million with $8 million due within 1 year, $20 million due between 1 and 3 years, and $130 million due in year 4.

The Company  s outstanding debt contains various terms, conditions and covenants which, if violated by the Company, would result in a default and could result in the acceleration of the Company  s payment obligations thereunder.

Unlike many other forms of contractual obligations, loss and loss adjustment expenses do not have definitive due dates and the ultimate payment dates are subject to a number of variables and uncertainties. As a result, the total loss and loss adjustment expense payments to be made by period, as shown above, are estimates.

The table excludes FIN No. 48 liabilities of $5 million related to uncertainty in tax settlements because the Company is unable to reasonably estimate the timing of related future payments.

***Regulatory Capital Requirement***

The NAIC utilizes a risk-based capital formula for casualty insurance companies which establishes recommended minimum capital requirements that are compared to the Company s actual capital level. The formula was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements and a number of other factors. The Company has calculated the risk-based capital requirements of each of the Insurance Companies as of December 31, 2007. The policyholders statutory surplus of each of the Insurance Companies exceeded the highest level of minimum required capital.

Industry and regulatory guidelines suggest that the ratio of a property and casualty insurer s annual net premiums written to statutory policyholders surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of $1,721.8 million at December 31, 2007, and net premiums written of $2,982.0 million, the ratio of premium writings to surplus was 1.7 to 1.

**New Accounting Standards**

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN No. 48 ). FIN No. 48 provides guidance on financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return related to uncertainties in income taxes. FIN No. 48 prescribes a more-likely-than-not recognition threshold that must be met before a tax benefit can be recognized in the financial statements. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company s adoption of FIN No. 48 did not have a material impact on its consolidated financial statements.

Effective January 1, 2007, the Company adopted American Institute of Certified Public Accountants ( AICPA ) Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts ( SOP 05-1 ). SOP 05-1 provides accounting guidance for deferred policy acquisition costs associated with internal replacements of insurance and investment contracts other than those already described in 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 ( SFAS No. 97 ). 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 Company s adoption of SOP 05-1 did not have a material impact on its consolidated financial statements.

Effective January 1, 2007, the Company adopted SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 ( SFAS No. 155 ). The provisions of SFAS No. 155 are effective for all financial instruments acquired or issued after the beginning of the first fiscal year after September 15, 2006. SFAS No. 155 amends the accounting for hybrid financial instruments and eliminates the exclusion of beneficial interests in securitized financial assets from the guidance under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. It also eliminates the prohibition on the type of derivative instruments that qualified special purpose entities may hold under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. Furthermore, SFAS No. 155 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. The Company s adoption of SFAS No. 155 did not have a material impact on its consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 is not expected to have a material impact on the Company s consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS No. 159 ). SFAS No. 159 permits an entity to measure certain financial assets and financial liabilities at fair value. The main objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity s election on its earnings, but does not eliminate disclosure requirements of other accounting standards. SFAS No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007.

The Company adopted SFAS No. 159 as of the beginning of 2008 and elected to apply the fair value option to all short-term investments and all available-for-sale fixed maturity and equity securities existing at the time of adoption and similar securities acquired subsequently unless otherwise noted at the time when the eligible item is first recognized, including hybrid financial instruments with embedded derivatives that would otherwise need to be bifurcated. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the FASB s long-term measurement objectives for accounting for financial instruments. As a result of adopting SFAS No. 159, a net unrealized gain of approximately $81 million, net of tax, related to available-for-sale securities was reclassified from accumulated other comprehensive income to retained earnings on January 1, 2008.

**Item 7A.** ***Quantitative and Qualitative Disclosures about Market Risks***

The Company is subject to various market risk exposures including interest rate risk and equity price risk. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

The Company invests its assets primarily in fixed maturity investments, which at December 31, 2007 comprised approximately 80% of total investments at fair value. Tax-exempt bonds represent 85% of the fixed maturity investments with the remaining amount consisting of sinking fund preferred stocks and taxable bonds. Equity securities account for approximately 12% of total investments at fair value. The remaining 8% of the investment portfolio consists of highly liquid short-term investments which are primarily short-term money market funds.

The value of the fixed maturity portfolio is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age of the expected cash flows. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity investments with a goal towards maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturity dates tend to produce higher current yields, the Company s historical investment philosophy resulted in a portfolio with a moderate duration. Bond investments made by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified duration of the bond portfolio is 4.4 years at

December 31, 2007 compared to 4.0 years and 2.9 years at December 31, 2006 and 2005, respectively. Given a hypothetical parallel increase of 100 basis points in interest rates, the fair value of the bond portfolio at December 31, 2007 would decrease by approximately $140 million.

At December 31, 2007, the Company s primary objective for common equity investments is current income with a secondary objective of capital appreciation. The fair value of the equity investment consists of $400.6 million in common stocks and $27.7 million in non-sinking fund preferred stocks. The common stock equity assets are typically valued for future economic prospects as perceived by the market. The non-sinking fund preferred stocks are typically valued using credit spreads to U.S. Treasury benchmarks. This causes them to be comparable to fixed income securities in terms of interest rate risk.

At December 31, 2007, the duration on the Company s non-sinking fund preferred stock portfolio was 11.8 years. This implies that an upward parallel shift in the yield curve by 100 basis points would reduce the asset value at December 31, 2007 by approximately $2.7 million, with all other factors remaining constant.

The common equity portfolio represents approximately 11% of total investments at fair value. Beta is a measure of a security s systematic (non-diversifiable) risk, which is the percentage change in an individual security s return for a 1% change in the return of the market. The average Beta for the Company s common stock holdings was 1.10. Based on a hypothetical 20% reduction in the overall value of the stock market, the fair value of the common stock portfolio would decrease by approximately $86 million.

Effective January 2, 2002, the Company entered into an interest rate swap of its fixed rate obligation on its $125 million fixed 7.25% rate senior notes for a floating rate. The interest rate swap has the effect of hedging the fair value of the senior notes.

**Forward-looking statements**

Certain statements in this report on Form 10-K or in other materials the Company has filed or will file with the SEC (as well as information included in oral statements or other written statements made or to be made by us) contain or may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may address, among other things, the Company s strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company s actual business, prospects and results of operations to differ materially from the historical information contained in this Form 10-K and from those that may be expressed or implied by the forward-looking statements contained in the this Form 10-K and in other reports or public statements made by us.

Factors that could cause or contribute to such differences include, among others: the competition currently existing in the California automobile insurance markets, the Company s success in expanding its business in states outside of California, the impact of potential third party bad-faith legislation, changes in laws or regulations, the outcome of tax position challenges by the California FTB, and decisions of courts, regulators and governmental bodies, particularly in California, the Company s ability to obtain and the timing of the approval of the California DOI for premium rate changes for private passenger automobile policies issued in California and similar rate approvals in other states where the Company does business, the level of investment yields the Company is able to obtain with its investments in comparison to recent yields and the market risk associated with its investment portfolio, the cyclical and general competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserve or other estimates, the accuracy and adequacy of the Company s pricing methodologies, uncertainties related to assumptions and projections generally, inflation and changes in economic conditions, changes in driving patterns and loss trends, acts of war and terrorist activities, court decisions and trends in litigation and health care and auto repair costs, and other uncertainties, and all of which are difficult to predict and many of which are beyond the Company s control. GAAP prescribes when reserves for particular risks including

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litigation exposures may be established. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

From time to time, forward-looking statements are also included in the Company s quarterly reports on Form 10-Q and current reports on Form 8-K, in press releases, in presentations, on its web site and in other materials released to the public. The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Form 10-K or, in the case of any document incorporated by reference, any other report filed with the SEC or any other public statement made by us, the date of the document, report or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company s forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in Item 1A. Risk Factors.

**Quarterly Financial Information**

Summarized quarterly financial data for 2007 and 2006 is as follows (in thousands except per share data):

| | Quarter Ended | | | |
|---|---|---|---|---|
| | **March 31** | **June 30** | **Sept. 30** | **Dec. 31** |
| **2007** | | | | |
| Earned premiums | $ 755,752 | $ 754,076 | $ 748,798 | $ 735,251 |
| Income before income taxes | $ 81,499 | $ 95,117 | $ 83,675 | $ 54,745 |
| Net income | $ 60,453 | $ 69,509 | $ 63,278 | $ 44,592 |
| Basic earnings per share | $ 1.11 | $ 1.27 | $ 1.16 | $ 0.81 |
| Diluted earnings per share | $ 1.10 | $ 1.27 | $ 1.15 | $ 0.81 |
| Dividends declared per share | $ 0.52 | $ 0.52 | $ 0.52 | $ 0.52 |
| **2006** | | | | |
| Earned premiums | $ 736,680 | $ 753,350 | $ 753,122 | $ 753,871 |
| Income before income taxes | $ 105,214 | $ 49,558 | $ 91,419 | $ 66,218 |
| Net income | $ 58,646 | $ 37,812 | $ 68,227 | $ 50,132 |
| Basic earnings per share | $ 1.07 | $ 0.69 | $ 1.25 | $ 0.92 |
| Diluted earnings per share | $ 1.07 | $ 0.69 | $ 1.25 | $ 0.91 |
| Dividends declared per share | $ 0.48 | $ 0.48 | $ 0.48 | $ 0.48 |

Quarterly results can be affected by many factors including development on loss reserves, catastrophes, realized gains and losses related to the timing of the sale or write-down of investments and the establishment of liabilities for loss contingencies that meet probability thresholds as required by GAAP. Net income in the fourth quarter of 2007 includes approximately $23 million ($15 million after tax benefit) in losses resulting from the October 2007 Southern California fire storms. For the quarter ended June 30, 2006, net income was negatively impacted by adverse loss reserve development of $35 million recorded for the Company s Florida and New Jersey automobile lines of business, partially offset by positive development of $15 million for business written in California.

**Item 8.** ***Financial Statements and Supplementary Data***

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors

Mercury General Corporation:

We have audited the accompanying consolidated balance sheets of Mercury General Corporation and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercury General Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercury General Corporation s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 25, 2008 expressed an unqualified opinion on the effectiveness of Mercury General Corporation and subsidiaries internal control over financial reporting.

/s/ KPMG LLP

Los Angeles, CA

February 25, 2008

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors

Mercury General Corporation:

We have audited Mercury General Corporation s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Mercury General Corporation 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, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process 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. 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that 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, Mercury General Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Mercury General Corporation as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated February 25, 2008 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Los Angeles, California

February 25, 2008

**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**December 31,**

**Amounts expressed in thousands, except share data**

| **ASSETS** | **2007** | **2006** |
|---|---|---|
| Investments: | | |
| Fixed maturities available for sale, at fair value (amortized cost $2,860,455 in 2007 and $2,851,715 in 2006) (includes hybrid financial instruments: $31,770 in 2007) | $ 2,887,760 | $ 2,898,987 |
| Equity securities available for sale, at fair value (cost $317,869 in 2007 and $258,310 in 2006) | 413,123 | 318,449 |
| Equity securities trading, at fair value (cost $13,126 in 2007) | 15,114 | |
| Short-term investments, at cost, which approximates fair value | 272,678 | 282,302 |
| Total investments | 3,588,675 | 3,499,738 |
| Cash | 48,245 | 47,606 |
| Receivables: | | |
| Premiums receivable | 294,663 | 298,772 |
| Premium notes | 27,577 | 29,613 |
| Accrued investment income | 36,436 | 34,307 |
| Other | 9,010 | 10,085 |
| Total receivables | 367,686 | 372,777 |
| Deferred policy acquisition costs | 209,805 | 209,783 |
| Fixed assets, net | 172,357 | 152,260 |
| Other assets | 27,728 | 18,898 |
| Total assets | $ 4,414,496 | $ 4,301,062 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Losses and loss adjustment expenses | $ 1,103,915 | $ 1,088,822 |
| Unearned premiums | 938,370 | 950,344 |
| Notes payable | 138,562 | 141,554 |
| Accounts payable and accrued expenses | 125,755 | 137,194 |
| Current income taxes | 3,150 | 18,241 |
| Deferred income taxes | 30,852 | 33,608 |
| Other liabilities | 211,894 | 207,169 |
| Total liabilities | 2,552,498 | 2,576,932 |
| Commitments and contingencies | | |
| Shareholders equity: | | |
| Common stock without par value or stated value: | | |
| Authorized 70,000,000 shares; issued and outstanding 54,729,913 shares in 2007 and 54,669,606 in 2006 | 69,369 | 66,436 |
| Accumulated other comprehensive income | 80,557 | 69,652 |

| | | |
|---|---|---|
| Retained earnings | 1,712,072 | 1,588,042 |
| Total shareholders equity | 1,861,998 | 1,724,130 |
| Total liabilities and shareholders equity | $ 4,414,496 | $ 4,301,062 |

See accompanying notes to consolidated financial statements.

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**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**Years ended December 31,**

**Amounts expressed in thousands, except per share data**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Revenues: | | | |
| Earned premiums | $ 2,993,877 | $ 2,997,023 | $ 2,847,733 |
| Net investment income | 158,911 | 151,099 | 122,582 |
| Net realized investment gains | 20,808 | 15,436 | 16,160 |
| Other | 5,154 | 5,185 | 5,438 |
| Total revenues | 3,178,750 | 3,168,743 | 2,991,913 |
| Expenses: | | | |
| Losses and loss adjustment expenses | 2,036,644 | 2,021,646 | 1,862,936 |
| Policy acquisition costs | 659,671 | 648,945 | 618,915 |
| Other operating expenses | 158,810 | 176,563 | 150,201 |
| Interest | 8,589 | 9,180 | 7,222 |
| Total expenses | 2,863,714 | 2,856,334 | 2,639,274 |
| Income before income taxes | 315,036 | 312,409 | 352,639 |
| Income tax expense | 77,204 | 97,592 | 99,380 |
| Net income | $ 237,832 | $ 214,817 | $ 253,259 |
| Basic earnings per share | $ 4.35 | $ 3.93 | $ 4.64 |
| Diluted earnings per share | $ 4.34 | $ 3.92 | $ 4.63 |

See accompanying notes to consolidated financial statements.

**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**Years ended December 31,**

**Amounts expressed in thousands**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Net income | $ 237,832 | $ 214,817 | $ 253,259 |
| Other comprehensive income (loss), before tax: | | | |
| Unrealized gains (losses) on securities: | | | |
| Unrealized holding gains (losses) arising during period | 25,583 | 12,144 | (10,687) |
| Less: reclassification adjustment for net gains included in net income | (8,800) | (7,373) | (10,868) |
| Other comprehensive income (loss), before tax | 16,783 | 4,771 | (21,555) |
| Income tax expense (benefit) related to unrealized holding gains (losses) arising during period | 8,958 | 4,248 | (3,751) |
| Income tax benefit related to reclassification adjustment for net gains included in net income | (3,080) | (2,580) | (3,804) |
| Comprehensive income, net of tax | $ 248,737 | $ 217,920 | $ 239,259 |

See accompanying notes to consolidated financial statements.

**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

**Years ended December 31,**

**Amounts expressed in thousands**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Common stock, beginning of year | $ 66,436 | $ 63,103 | $ 60,206 |
| Proceeds of stock options exercised | 2,173 | 1,943 | 2,394 |
| Share-based compensation expense | 487 | 885 | |
| Tax benefit on sales of incentive stock options | 273 | 505 | 503 |
| Common stock, end of year | 69,369 | 66,436 | 63,103 |
| Accumulated other comprehensive income, beginning of year | 69,652 | 66,549 | 80,549 |
| Net increase (decrease) in other comprehensive income, net of tax | 10,905 | 3,103 | (14,000) |
| Accumulated other comprehensive income, end of year | 80,557 | 69,652 | 66,549 |
| Retained earnings, beginning of year | 1,588,042 | 1,478,185 | 1,318,793 |
| Net income | 237,832 | 214,817 | 253,259 |
| Dividends paid to shareholders | (113,802) | (104,960) | (93,867) |
| Retained earnings, end of year | 1,712,072 | 1,588,042 | 1,478,185 |
| Total shareholders equity | $ 1,861,998 | $ 1,724,130 | $ 1,607,837 |

See accompanying notes to consolidated financial statements.

**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Years Ended December 31,**

**Amounts expressed in thousands**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 237,832 | $ 214,817 | $ 253,259 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 26,324 | 24,262 | 18,781 |
| Net realized investment gains | (20,808) | (15,436) | (16,160) |
| Bond amortization, net | 7,414 | 4,701 | 11,814 |
| Excess tax benefit from exercise of stock options | (273) | (505) | |
| Decrease (increase) in premiums receivable | 4,109 | (13,989) | (14,741) |
| Decrease (increase) in premium notes receivable | 2,036 | (2,611) | (3,300) |
| Increase in deferred policy acquisition costs | (22) | (11,840) | (23,103) |
| Increase in unpaid losses and loss adjustment expenses | 15,093 | 66,219 | 121,859 |
| (Decrease) increase in unearned premiums | (11,974) | 47,777 | 102,888 |
| (Decrease) increase in accrued income taxes payable, excluding deferred tax on change in unrealized gain | (21,817) | 24,435 | (6,443) |
| Decrease in accounts payable and accrued expenses | (11,439) | (467) | (1,175) |
| Net increase in trading securities | (10,101) | | |
| Share-based compensation | 487 | 886 | |
| Other, net | (740) | 24,947 | 62,114 |
| Net cash provided by operating activities | 216,121 | 363,196 | 505,793 |
| Cash flows from investing activities: | | | |
| Fixed maturities available for sale: | | | |
| Purchases | (1,782,206) | (2,701,195) | (1,787,879) |
| Sales | 1,442,863 | 1,912,718 | 937,481 |
| Calls or maturities | 311,714 | 522,193 | 409,520 |
| Equity securities available for sale: | | | |
| Purchases | (578,573) | (429,564) | (406,974) |
| Sales | 546,314 | 404,730 | 401,016 |
| (Decrease) increase in payable for securities, net | (5,141) | 949 | 250 |
| Net decrease in short-term investments | 9,624 | 38,747 | 100,320 |
| Purchase of fixed assets | (42,036) | (40,644) | (42,211) |
| Sale of fixed assets | 1,110 | 529 | 1,211 |
| Other, net | 3,455 | 8,675 | 3,442 |
| Net cash used in investing activities | (92,876) | (282,862) | (383,824) |
| Cash flows from financing activities: | | | |
| Dividends paid to shareholders | (113,802) | (104,960) | (93,867) |
| Excess tax benefit from exercise of stock options | 273 | 505 | |
| Mortgage loan pay-off | (11,250) | | |

| | | | |
|---|---|---|---|
| Proceeds from stock options exercised | 2,173 | 1,943 | 2,394 |
| Net cash used in financing activities | (122,606) | (102,512) | (91,473) |
| Net increase (decrease) in cash | 639 | (22,178) | 30,496 |
| Cash: | | | |
| Beginning of the year | 47,606 | 69,784 | 39,288 |
| End of the year | $ 48,245 | $ 47,606 | $ 69,784 |

See accompanying notes to consolidated financial statements.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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## (1) Significant Accounting Policies

### *Principles of Consolidation and Presentation*

The Company operates primarily as a private passenger automobile insurer selling policies through a network of independent agents and brokers in thirteen states. The Company also offers homeowners insurance, commercial automobile and property insurance, mechanical breakdown insurance, commercial and dwelling fire insurance and umbrella insurance. The private passenger automobile lines of insurance exceeded 83% of the Company s net premiums written in 2007, 2006 and 2005, with approximately 79%, 75% and 73% of the private passenger automobile premiums written in the state of California during 2007, 2006 and 2005, respectively.

The consolidated financial statements include the accounts of Mercury General Corporation (the Company ) and its wholly-owned subsidiaries, Mercury Casualty Company, Mercury Insurance Company, California Automobile Insurance Company, California General Underwriters Insurance Company, Inc., Mercury Insurance Company of Georgia, Mercury Insurance Company of Illinois, Mercury Insurance Company of Florida, Mercury Indemnity Company of Georgia, Mercury National Insurance Company, Mercury Indemnity Company of America, Mercury Insurance Services, LLC ( MISLLC ), American Mercury Insurance Company ( AMI ), Mercury Select Management Company, Inc. ( MSMC ), American Mercury Lloyds Insurance Company ( AML ) and Mercury County Mutual Insurance Company ( MCM ). American Mercury MGA, Inc. ( AMMGA ) is a wholly-owned subsidiary of AMI. AML is not owned by the Company, but is controlled by the Company through its attorney-in-fact, MSMC. MCM is not owned by the Company, but is controlled through a management contract and therefore its results are included in the consolidated financial statements. The consolidated financial statements also include Concord Insurance Services, Inc. ( Concord ), a Texas insurance agency owned by the Company. All of the subsidiaries as a group, including AML and MCM, but excluding MSMC, AMMGA, and MISLLC, are referred to as the Insurance Companies. The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ( GAAP ), which differ in some respects from those filed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most significant assumptions in the preparation of these consolidated financial statements relate to loss and loss adjustment expenses. Actual results could differ from those estimates.

### *Investments*

Fixed maturities available-for-sale include those securities that management intends to hold for indefinite periods, but which may be sold in response to changes in interest rates, tax planning considerations or other aspects of asset/liability management. Fixed maturities available-for-sale, which include bonds and sinking fund preferred stocks, are carried at fair value. Investments in equity securities, which include common stocks and non-redeemable preferred stocks, are carried at fair value. Short-term investments are carried at cost, which approximates fair value.

With limited exceptions, the market valuations were drawn from standard trade data sources. In no case was any valuation made by the Company s management using models. Fixed maturities are amortized using first call date and are adjusted for anticipated prepayments. Mortgage-backed securities at amortized cost are adjusted for anticipated prepayment using the prospective method. Equity holdings, including non-sinking fund preferred stocks, are, with minor exceptions, actively traded on national exchanges and were valued at the last transaction price on the balance sheet date.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

Temporary unrealized gains and losses for investments available for sale, except for those accounted for under Statement of Financial Accounting Standards ( SFAS ) No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS No. 133 ) and SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133 and SFAS No. 140 ( SFAS No. 155 ), are credited or charged directly to shareholders equity as part of accumulated other comprehensive income (loss), net of applicable taxes. Changes in fair value for those investments accounted for under SFAS No. 133 and SFAS No. 155, as well as for trading securities accounted for under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities ( SFAS No. 115 ), are reflected in net realized gains or losses in the consolidated statements of income. When a decline in value of fixed maturities or equity securities is considered other than temporary, a loss is recognized in the consolidated statements of income. Realized capital gains and losses are included in the consolidated statements of income based upon the specific identification method.

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company on the expiration date as realized gains from investments. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option.

***Fair Value of Financial Instruments***

Under SFAS No. 115, the Company categorizes all of its investments in debt securities and the majority of equity securities as available-for-sale. The remaining equity securities are categorized as trading. Accordingly, all investments, including cash and short-term investments, are carried on the balance sheet at their fair value. The carrying amounts and fair values for investment securities are disclosed in Note 2 of Notes to Consolidated Financial Statements and were drawn from standard trade data sources such as market and broker quotes. The carrying value of receivables, accounts payable and accrued expenses and other liabilities is equivalent to the estimated fair value of those items.

***Premium Income Recognition***

Insurance premiums are recognized as income ratably over the term of the policies, that is, in proportion to the amount of insurance protection provided. Unearned premiums are computed on a monthly pro rata basis. Unearned premiums are stated gross of reinsurance deductions, with the reinsurance deduction recorded in other assets and other receivables. Net premiums of $2.98 billion, $3.04 billion, and $2.95 billion were written in 2007, 2006 and 2005, respectively.

One broker produced direct premiums written of approximately 14%, 13% and 14% of the Company s total direct premiums written during 2007, 2006 and 2005, respectively. No other agent or broker accounted for more than 2% of direct premiums written.

***Premium Notes***

Premium notes receivable represent the balance due to the Company from policyholders who elect to finance their premiums over the policy term. The Company requires both a down payment and monthly payments as part of its financing program. Premium finance fees are charged to policyholders who elect to finance premiums. The fees

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

are charged at rates that vary with the amount of premium financed. Premium finance fees are recognized over the term of the premium note based upon the effective yield.

***Deferred Policy Acquisition Costs***

Acquisition costs related to unearned premiums, which consist of commissions, premium taxes and certain other underwriting costs, and which vary directly with and are directly related to the production of business, are deferred and amortized to expense ratably over the terms of the policies. Deferred acquisition costs are limited to the amount which will remain after deducting from unearned premiums and anticipated investment income the estimated losses and loss adjustment expenses and the servicing costs that will be incurred as the premiums are earned. The Company does not defer advertising expenses.

***Losses and Loss Adjustment Expenses***

The liability for losses and loss adjustment expenses is based upon the accumulation of individual case estimates for losses reported prior to the close of the accounting period, plus estimates, based upon past experience, of ultimate developed costs which may differ from case estimates and estimates of unreported claims. The liability is stated net of anticipated salvage and subrogation recoveries. The amount of reinsurance recoverable is included in other receivables.

Estimating loss reserves is a difficult process as there are many factors that can ultimately affect the final settlement of a claim and, therefore, the reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials or labor rates can impact ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the occurrence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement amount can be. Accordingly, short-tail property damage claims tend to be more reasonably predictable than long-tail liability claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date. Since the provisions for loss reserves are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company analyzes loss reserves quarterly primarily using the incurred loss development, average severity and claim count development methods described below. The Company also uses the paid loss development method to analyze loss adjustment expense reserves and industry claims data as part of its reserve analysis. When deciding which method to use in estimating its reserves, the Company and its actuaries evaluate the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of business or coverage within a line of business. When establishing the reserve, the Company will generally analyze the results from all of the methods used rather than relying on one method. While these methods are designed to determine the ultimate losses on claims under the Company s policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The *incurred loss development method* analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss development method provides a reasonable basis for evaluating ultimate losses, particularly in the Company s larger, more established lines of business which have a long operating history.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

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The *claim count development method* analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The *average severity method* analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The *average severity method* coupled with the *claim count development method* provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing reserves.

The *paid loss development method* analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company primarily uses this method for loss adjustment expenses because specific case reserves are generally not established for loss adjustment expenses.

In states with little operating history where there are insufficient claims data to prepare a reserve analysis relying solely on Company historical data, the Company generally projects ultimate losses using industry average loss data or expected loss ratios. As the Company develops an operating history in these states, the Company will rely increasingly on the incurred loss development and average severity and claim count development methods. The Company analyzes catastrophe losses separately from non-catastrophe losses. For these losses, the Company determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on reserves established by adjusters and average losses on previous storms.

***Depreciation and Amortization***

Buildings are stated at the lower of cost or fair value and depreciated on a straight line basis over 30 years. Furniture and equipment and purchased software are stated at cost and depreciated on a combination of straight-line and accelerated methods over 3 to 10 years. Automobiles are depreciated over 5 years, using an accelerated method. Internally developed computer software is capitalized in accordance with Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, and amortized on a straight-line method over the estimated useful life of the software, not exceeding five years. Leasehold improvements are stated at cost and amortized over the life of the associated lease.

***Derivative Financial Instruments***

The Company accounts for derivative financial instruments in accordance with SFAS No. 133, as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Hedging Activities, and SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. The Company has entered into a hedge transaction that converts fixed rate debt to variable rate debt, effectively hedging the change in fair value of the fixed rate debt resulting from fluctuations in interest rates. The carrying values of the derivative designated as a fair value hedging instrument and the fixed rate debt are adjusted to fair values in accordance with SFAS No. 133, as amended, as discussed in Note 5 of Notes to Consolidated Financial Statements.

***Earnings Per Share***

Earnings per share is presented in accordance with the provisions of SFAS No. 128, Earnings per Share, which requires presentation of basic and diluted earnings per share for all publicly traded companies. Note 13 of Notes to Consolidated Financial Statements contains the required disclosures which make up the calculation of basic and diluted earnings per share.

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***Segment Reporting***

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for reporting information about operating segments. The Company does not have any operations that require separate disclosure as operating segments.

***Income Taxes***

The Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company s assets and liabilities and expected benefits of utilizing net operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The impact on deferred taxes of changes in tax rates and laws, if any, are applied to the years during which temporary differences are expected to be settled, and reflected in the financial statements in the period enacted.

***Reinsurance***

Liabilities for unearned premiums and unpaid losses are stated in the accompanying consolidated financial statements before deductions for ceded reinsurance. The ceded amounts are immaterial and are carried in other receivables. Earned premiums are stated net of deductions for ceded reinsurance.

The Insurance Companies, as primary insurers, are required to pay losses to the extent reinsurers are unable to discharge their obligations under the reinsurance agreements.

***Supplemental Cash Flow Information***

A summary of interest and income taxes paid is as follows:

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (Amounts in thousands) | | |
| Interest | $ 8,618 | $ 8,702 | $ 5,649 |
| Income taxes | 100,410 | 73,144 | 105,811 |

In 2007, the Company issued a promissory note of $4.5 million that is due in April 2009 in connection with the acquisition of a 4.25 acre parcel of land in Brea, California.

***Share-Based Compensation***

Prior to January 1, 2006, the Company accounted for share-based compensation plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Under that method, when options are granted with a strike price equal to or greater than market price on the date of issuance, there is no impact on earnings either on the date of the grant or thereafter, absent modification to the options. Accordingly, the Company recognized no share-based compensation expense in periods prior to January 1, 2006.

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ), using the modified prospective transition method and therefore has not restated results from

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

prior periods. Under this transition method, share-based compensation expense for 2006 includes compensation expense for all share-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of generally five years, for only those shares expected to vest. The fair value of stock option awards was estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values, as discussed in Note 12 of Notes to Consolidated Financial Statements.

***Recently Issued Accounting Standards***

Effective January 1, 2007, the Company adopted the Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN No. 48 ). FIN No. 48 provides guidance on financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return related to uncertainties in income taxes. FIN No. 48 prescribes a more-likely-than-not recognition threshold that must be met before a tax benefit can be recognized in the financial statements. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company s adoption of FIN No. 48 did not have a material impact on its consolidated financial statements.

Effective January 1, 2007, the Company adopted the American Institute of Certified Public Accountants ( AICPA ) Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts ( SOP 05-1 ). SOP 05-1 provides accounting guidance for deferred policy acquisition costs associated with internal replacements of insurance and investment contracts other than those already described in 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 Company s adoption of SOP 05-1 did not have a material impact on its consolidated financial statements.

Effective January 1, 2007, the Company adopted SFAS No. 155. The provisions of SFAS No. 155 are effective for all financial instruments acquired or issued after the beginning of the first fiscal year after September 15, 2006. SFAS No. 155 amends the accounting for hybrid financial instruments and eliminates the exclusion of beneficial interests in securitized financial assets from the guidance under SFAS No.133. It also eliminates the prohibition on the type of derivative instruments that qualified special purpose entities may hold under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. Furthermore, SFAS No. 155 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. The Company s adoption of SFAS No. 155 did not have a material impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 is not expected to have a material impact on the Company s consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS No. 159 ). SFAS No. 159 permits an entity to measure certain financial assets and financial liabilities at fair value. The main objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity s election on its earnings, but does not eliminate disclosure requirements of other accounting standards. SFAS No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007.

The Company adopted SFAS No. 159 as of the beginning of 2008 and elected to apply the fair value option to all short-term investments and all available-for-sale fixed maturity and equity securities existing at the time of adoption and similar securities acquired subsequently unless otherwise noted at the time when the eligible item is first recognized, including hybrid financial instruments with embedded derivatives that would otherwise need to be bifurcated. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the FASB s long-term measurement objectives for accounting for financial instruments. As a result of adopting SFAS No. 159, a net unrealized gain of approximately $81 million, net of tax, related to available-for-sale securities was reclassified from accumulated other comprehensive income to retained earnings on January 1, 2008.

***Reclassifications***

Certain reclassifications have been made to the prior year balances to conform to the current year presentation.

**(2) Investments and Investment Income**

***Investment Income***

A summary of net investment income is shown in the following table:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| | (Amounts in thousands) | | |
| Interest and dividends on fixed maturities | $ 141,021 | $ 130,339 | $ 100,403 |
| Dividends on equity securities | 9,476 | 8,152 | 10,149 |
| Interest on short-term investments | 13,452 | 15,557 | 13,827 |
| Total investment income | 163,949 | 154,048 | 124,379 |
| Investment expense | 5,038 | 2,949 | 1,797 |
| Net investment income | $ 158,911 | $ 151,099 | $ 122,582 |

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

***Realized Investment Gains and Losses***

A summary of net realized investment gains and losses is as follows:

| | Year ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (Amounts in thousands) | | |
| Net realized investment gains (losses): | | | |
| Fixed maturities | $ (12,830) | $ (3,611) | $ (280) |
| Equity securities | 33,638 | 19,047 | 16,440 |
| | $ 20,808 | $ 15,436 | $ 16,160 |

Net realized investment gains (losses) includes investment write-downs considered to be other-than-temporary impairment losses of $22.7 million, $2.0 million, and $2.2 million in 2007, 2006, and 2005, respectively. In addition, in 2007, net realized investment gains and losses also includes $2.0 million gain and $1.4 million loss related to the change in the fair value of trading securities and hybrid financial instruments, respectively.

Gross gains and losses realized on the sales of investments (excluding calls) are shown below:

| | Year ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (Amounts in thousands) | | |
| Fixed maturities available for sale: | | | |
| Gross realized gains | $ 1,626 | $ 541 | $ 604 |
| Gross realized losses | (4,196) | (3,778) | (1,539) |
| Net | $ (2,570) | $ (3,237) | $ (935) |
| Equity securities available for sale: | | | |
| Gross realized gains | $ 69,288 | $ 30,990 | $ 26,799 |
| Gross realized losses | (20,773) | (10,955) | (8,330) |
| Net | $ 48,515 | $ 20,035 | $ 18,469 |

| | | | |
|---|---|---|---|
| Equity securities trading: | | | |
| Gross realized gains | $ 7,145 | $ | $ |
| Gross realized losses | (5,431) | | |
| Net | $ 1,714 | $ | $ |

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

***Unrealized Investment Gains and Losses***

A summary of the net increase (decrease) in unrealized investment gains and losses less applicable income tax expense (benefit) is as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| | (Amounts in thousands) | | |
| Net increase (decrease) in net unrealized investment gains and losses: | | | |
| Fixed maturities available for sale | $ (18,612) | $ (4,538) | $ (28,546) |
| Income tax benefit | (6,514) | (1,589) | (9,990) |
| | $ (12,098) | $ (2,949) | $ (18,556) |
| Equity securities | $ 35,382 | $ 9,311 | $ 6,988 |
| Income tax expense | 12,379 | 3,259 | 2,432 |
| | $ 23,003 | $ 6,052 | $ 4,556 |

Accumulated unrealized gains and losses on securities available for sale are as follows:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| | (Amounts in thousands) | |
| Fixed maturities available for sale: | | |
| Unrealized gains | $ 54,975 | $ 63,705 |
| Unrealized losses | (26,314) | (16,433) |
| Tax effect | (10,031) | (16,545) |
| | $ 18,630 | $ 30,727 |
| Equity securities available for sale: | | |
| Unrealized gains | $ 104,717 | $ 65,709 |
| Unrealized losses | (9,463) | (5,837) |
| Tax effect | (33,326) | (20,947) |
| | $ 61,928 | $ 38,925 |

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

***Fair Value of Investments***

The amortized cost and estimated fair value of investments in fixed maturities available-for-sale (excluding hybrid financial instruments with an estimated fair value of $31.8 million) as of December 31, 2007 are as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| | | (Amounts in thousands) | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 36,157 | $ 283 | $ 65 | $ 36,375 |
| Obligations of states and political subdivisions | 2,435,215 | 49,878 | 20,552 | 2,464,541 |
| Mortgage-backed securities | 227,606 | 2,018 | 2,049 | 227,575 |
| Corporate securities | 126,272 | 2,789 | 3,633 | 125,428 |
| Redeemable preferred stock | 2,079 | 7 | 15 | 2,071 |
| Totals | $ 2,827,329 | $ 54,975 | $ 26,314 | $ 2,855,990 |

The amortized cost and estimated fair value of investments in fixed maturities available-for-sale as of December 31, 2006 are as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| | | (Amounts in thousands) | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 133,733 | $ 36 | $ 1,292 | $ 132,477 |
| Obligations of states and political subdivisions | 2,282,877 | 59,780 | 6,695 | 2,335,962 |
| Mortgage-backed securities | 273,420 | 1,179 | 2,866 | 271,733 |
| Corporate securities | 157,893 | 2,709 | 5,553 | 155,049 |
| Redeemable preferred stock | 3,792 | 1 | 27 | 3,766 |
| Totals | $ 2,851,715 | $ 63,705 | $ 16,433 | $ 2,898,987 |

The Company monitors its investments closely. If an unrealized loss is determined to be other than temporary, it is written off as a realized loss through the consolidated statements of income. The Company s assessment of other-than-temporary impairments is security-specific as of the balance sheet date and considers various factors including the length of time and the extent to which the fair value has been lower than the cost, the financial condition and the near-term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, and the Company s intent and ability to hold the securities until they mature or recover their value. The Company recognized $22.7 million and $2.0 million in realized losses as other-than-temporary declines to its investment securities during 2007 and 2006, respectively.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

The following table illustrates the gross unrealized losses on securities available for sale and the fair value of those securities, aggregated by investment category as of December 31, 2007. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of December 31, 2007.

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value |
| | | | (Amounts in thousands) | | | |
| U.S. Treasury Securities and obligations of U.S. government corporations and agencies | $ 64 | $ 13,140 | $ 1 | $ 1,300 | $ 65 | $ 14,440 |
| Obligations of states and political subdivisions | 12,342 | 788,701 | 8,210 | 294,940 | 20,552 | 1,083,641 |
| Corporate securities | 2,177 | 18,141 | 1,456 | 48,444 | 3,633 | 66,585 |
| Mortgage-backed securities | 606 | 35,733 | 1,443 | 64,509 | 2,049 | 100,242 |
| Redeemable preferred stock | 4 | 492 | 11 | 1,184 | 15 | 1,676 |
| Subtotal, debt securities | 15,193 | 856,207 | 11,121 | 410,377 | 26,314 | 1,266,584 |
| Equity securities | 8,882 | 81,215 | 581 | 4,060 | 9,463 | 85,275 |
| Total temporarily impaired securities | $ 24,075 | $ 937,422 | $ 11,702 | $ 414,437 | $ 35,777 | $ 1,351,859 |

The $35.8 million gross unrealized losses on securities available for sale represents 1.03% of total investments at amortized cost. These unrealized losses consist mostly of individual securities with unrealized losses of less than 20% of each security s amortized cost. Of these, the most significant unrealized loss relates to one corporate bond with an unrealized loss of approximately $1.3 million and with a market value decline of 13% of amortized cost. Approximately $1.2 million of the total gross unrealized losses relates to 26 individual equity securities and one fixed maturity security with unrealized losses that exceed 20% of each security s amortized cost. None of these 27 securities have unrealized losses greater than $0.1 million nor have they been in an unrealized loss position for more than 12 months.

Based upon the Company s analysis of the securities, which includes consideration of the status of debt servicing for fixed maturities and third party analyst estimates for the equity securities, and the Company s intent and ability to hold the securities until they mature or recover their costs, the Company has concluded that the gross unrealized losses of $35.8 million at December 31, 2007 were temporary in nature. However, facts and circumstances may change which could result in a decline in fair value considered to be other than temporary.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

The following table illustrates the gross unrealized losses on securities available for sale and the fair value of those securities, aggregated by investment category as of December 31, 2006. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of December 31, 2006.

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value |
| | | | (Amounts in thousands) | | | |
| U.S. Treasury Securities and obligations of U.S. government corporations and agencies | $ 127 | $ 34,167 | $ 1,165 | $ 84,517 | $ 1,292 | $ 118,684 |
| Obligations of states and political subdivisions | 3,140 | 436,060 | 3,555 | 181,190 | 6,695 | 617,250 |
| Corporate securities | 927 | 39,263 | 4,626 | 61,136 | 5,553 | 100,399 |
| Mortgage-backed securities | 1,043 | 83,784 | 1,823 | 70,457 | 2,866 | 154,241 |
| Redeemable preferred stock | 27 | 2,772 | | | 27 | 2,772 |
| Subtotal, debt securities | 5,264 | 596,046 | 11,169 | 397,300 | 16,433 | 993,346 |
| Equity securities | 5,153 | 48,653 | 684 | 15,323 | 5,837 | 63,976 |
| Total temporarily impaired securities | $ 10,417 | $ 644,699 | $ 11,853 | $ 412,623 | $ 22,270 | $ 1,057,322 |

Unrealized losses that have been in a continuous unrealized loss position over 12 months are mostly accounted for by unrealized losses of fixed maturity securities, and amounted to 0.3% of the total investment market value at December 31, 2007 compared to 0.3% at December 31, 2006. The increase from December 31, 2006 to December 31, 2007 in the total unrealized losses is predominantly in the obligations of states and political subdivisions (municipal bond) category and relates primarily to the credit market dislocation experienced during 2007.

At December 31, 2007, bond holdings rated below investment grade were 1.3% of total investments at fair value. The average rating of the bond portfolio was AA, investment grade. Additionally, the Company owns securities that are credit enhanced by financial guarantors that are subject to uncertainty related to market perception of the guarantors ability to perform. Determining the estimated fair value of municipal bonds could become more difficult should markets for these securities become illiquid. The amortized cost and estimated fair value of fixed maturities available for sale at December 31, 2007 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| | (Amounts in thousands) | |
| Fixed maturities available for sale: | | |

| | | |
|---|---|---|
| Due in one year or less | $ 34,688 | $ 34,191 |
| Due after one year through five years | 197,290 | 199,567 |
| Due after five years through ten years | 637,127 | 656,959 |
| Due after ten years | 1,745,619 | 1,750,971 |
| Mortgage-backed securities | 245,731 | 246,072 |
| | $ 2,860,455 | $ 2,887,760 |

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

## (3) Fixed Assets

A summary of fixed assets follows:

| | December 31, 2007 | December 31, 2006 |
|---|---|---|
| | (Amounts in thousands) | |
| Land | $ 23,353 | $ 15,848 |
| Buildings | 94,827 | 87,529 |
| Furniture and equipment | 116,531 | 110,159 |
| Capitalized software | 74,307 | 52,361 |
| Leasehold improvements | 4,468 | 4,211 |
| | 313,486 | 270,108 |
| Less accumulated depreciation | (141,129) | (117,848) |
| Net fixed assets | $ 172,357 | $ 152,260 |

Depreciation expense including amortization of leasehold improvements was $26.3 million, $24.3 million, and $18.8 million during 2007, 2006 and 2005, respectively.

## (4) Deferred Policy Acquisition Costs

Policy acquisition costs incurred and amortized are as follows:

| | Year ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (Amounts in thousands) | | |
| Balance, beginning of year | $ 209,783 | $ 197,943 | $ 174,840 |
| Costs deferred during the year | 659,692 | 660,785 | 642,018 |
| Amortization charged to expense | (659,670) | (648,945) | (618,915) |
| Balance, end of year | $ 209,805 | $ 209,783 | $ 197,943 |

**(5) Notes Payable**

Notes Payable consists of the following:

| | December 31, 2007 | 2006 |
|---|---|---|
| | (Amounts in thousands) | |
| Unsecured senior notes | $ 134,062 | $ 130,304 |
| Mortgage note | | 11,250 |
| Secured promissory note | 4,500 | |
| | $ 138,562 | $ 141,554 |

On August 7, 2001, the Company issued $125 million of senior notes payable. The notes are unsecured, senior obligations of the Company with a 7.25% annual coupon rate payable on February 15 and August 15 each year. The notes mature on August 15, 2011. The Company incurred debt issuance costs of approximately $1.3 million, inclusive of underwriter s fees. These costs are deferred and then amortized as a component of interest expense over the term of the notes. The notes were issued at a slight discount of 99.723%, resulting in the effective annualized interest rate including debt issuance costs of approximately 7.44%.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

Effective January 2, 2002, the Company entered into an interest rate swap of its fixed rate obligation on the senior notes for a floating rate of LIBOR plus 107 basis points. The swap agreement terminates on August 15, 2011 and includes an early termination option exercisable by either party on the fifth anniversary or each subsequent anniversary by providing sufficient notice, as defined. The swap reduced interest expense in 2005, 2006 and 2007, but does expose the Company to higher interest expense in future periods if LIBOR rates increase. The effective annualized interest rate was 6.4% and 6.6% in 2007 and 2006, respectively. The swap is designated as a fair value hedge and qualifies for the shortcut method under SFAS No. 133, because the hedge is deemed to have no ineffectiveness. The fair value of the interest rate swap was $9,218,000 and $5,496,000 at December 31, 2007 and 2006, respectively, and has been recorded in other assets in the consolidated balance sheets with a corresponding increase to notes payable. The interest rate swap was determined to be highly effective and no amount of ineffectiveness was recorded in earnings during 2007 and 2006.

In October 2007, the Company completed the acquisition of a 4.25 acre parcel of land in Brea, California. In conjunction with the purchase, the Company entered into an 18-month lease agreement with the seller allowing the seller to use the property during the lease term. Also, as part of the acquisition, the Company issued a secured promissory note in the amount of $4,500,000 without interest. The note is payable three business days after the Company receives a written notice from the seller that the property has been vacated in accordance with the lease.

The aggregated maturities for notes payable are as follows:

| Year | Maturity |
|---|---|
| 2008 | $ 0 |
| 2009 | $ 4,500,000 |
| 2010 | $ 0 |
| 2011 | $ 125,000,000 |

## (6) Income Taxes

### *Income tax provision*

The Company and its subsidiaries file a consolidated Federal income tax return. The provision for income tax expense (benefit) consists of the following components:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| | (Amounts in thousands) | | |
| Federal | | | |
| Current | $ 82,016 | $ 80,069 | $ 82,509 |
| Deferred | (7,844) | (7,169) | 13,520 |
| | $ 74,172 | $ 72,900 | $ 96,029 |
| State | | | |
| Current | $ 1,994 | $ 23,039 | $ 2,463 |
| Deferred | 1,038 | 1,653 | 888 |
| | $ 3,032 | $ 24,692 | $ 3,351 |
| Total | | | |
| Current | $ 84,010 | $ 103,108 | $ 84,972 |
| Deferred | (6,806) | (5,516) | 14,408 |
| Total | $ 77,204 | $ 97,592 | $ 99,380 |

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

The income tax provision reflected in the consolidated statements of income is less than the expected federal income tax on income before income taxes as shown in the table below:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| | (Amounts in thousands) | | |
| Computed tax expense at 35% | $ 110,263 | $ 109,343 | $ 123,424 |
| Tax-exempt interest income | (38,254) | (33,325) | (28,187) |
| Dividends received deduction | (2,087) | (1,902) | (2,333) |
| Reduction of losses incurred deduction for 15% of income on securities purchased after August 7, 1986 | 6,014 | 5,245 | 4,474 |
| Other, net | 1,268 | 18,231 | 2,002 |
| Income tax expense | $ 77,204 | $ 97,592 | $ 99,380 |

***Deferred Tax Asset and Liability***

The temporary differences that give rise to a significant portion of the deferred tax asset (liability) relate to the following:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| | (Amounts in thousands) | |
| Deferred tax assets | | |
| 20% of net unearned premium | $ 68,027 | $ 68,975 |
| Discounting of loss reserves and salvage and subrogation recoverable for tax purposes | 15,941 | 17,812 |
| Write-down of impaired investments | 11,549 | 4,757 |
| Other deferred tax assets | 10,800 | 3,478 |
| Total gross deferred tax assets | 106,317 | 95,022 |
| Deferred tax liabilities | | |
| Deferred acquisition costs | (73,432) | (73,424) |
| Tax liability on net unrealized gain on securities carried at fair value | (43,357) | (37,492) |
| Tax depreciation in excess of book depreciation | (10,073) | (10,967) |
| Accretion on bonds | (945) | (914) |
| Undistributed earnings of insurance subsidiaries | (5,113) | (4,510) |
| Other deferred tax liabilities | (4,249) | (1,323) |

| | | |
|---|---|---|
| Total gross deferred tax liabilities | (137,169) | (128,630) |
| Net deferred tax liabilities | $ (30,852) | $ (33,608) |

Realization of deferred tax assets is dependent on generating sufficient taxable income prior to their expiration. Although realization is not assured, management believes it is more likely than not that the deferred tax assets will be realized.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

***Uncertainty in Income Taxes***

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. The tax years that remain subject to examination by major taxing jurisdictions are 2004 through 2006 for federal taxes and 2001 through 2006 for California state taxes.

On March 28, 2006, the California State Board of Equalization ( SBE ) upheld Notices of Proposed Assessments issued against the Company for tax years 1993 through 1996 in which the Franchise Tax Board ( FTB ) disallowed a portion of the Company s expenses related to management services provided to its insurance subsidiaries on grounds that such expenses were allocable to the Company s tax-deductible dividends from such subsidiaries. The SBE decision resulted in a smaller disallowance of the Company s interest expense deductions than was proposed by the FTB in those years. As a result of this ruling, the Company recorded an income tax charge (including penalties and interest) of approximately $15 million, after federal tax benefit, in the first quarter of 2006. The Company believes that the deduction of the expenses related to management services provided to its insurance subsidiaries is appropriate and is challenging the SBE decision in Superior Court.

The California FTB has audited the 1997 through 2002 and 2004 tax returns and accepted the 1997 through 2000 returns to be correct as filed. The Company received a notice of examination for the 2003 tax return from the FTB in January 2008. For the Company s 2001, 2002, and 2004 tax returns, the FTB has taken exception to the state apportionment factors used by the Company. Specifically, the FTB has asserted that payroll and property factors from Mercury Insurance Services, LLC, a subsidiary of Mercury Casualty Company that are excluded from the Mercury General California Franchise tax return, should be included in the California apportionment factors. In addition, for the 2004 tax return, the FTB has asserted that a portion of management fee expenses paid by Mercury Insurance Services, LLC should be disallowed. Based on these assertions, the FTB has issued notices of proposed tax assessments for the 2001, 2002 and 2004 tax years, totaling approximately $5 million. The Company strongly disagrees with the position taken by the FTB and plans to formally appeal the assessments before the SBE. An unfavorable ruling against the Company may have a material impact on the Company s results of operations in the period of such ruling. Management believes that the issue will ultimately be resolved in favor of the Company. However, there can be no assurance that the Company will prevail on this matter.

The Company adopted the provisions of FIN No. 48 on January 1, 2007. No adjustment to the Company s financial position was required as a result of the implementation of this Interpretation.

A reconciliation of the beginning and ending balances of unrecognized tax benefits is as follows:

| | |
|---|---|
| Balance at January 1, 2007 | $ 7,382,000 |
| Additions based on tax positions related to the current year | 921,000 |
| Additions for tax positions of prior years | 289,000 |
| Reductions for tax positions related to the current year | |
| Reductions for tax positions of prior years | (4,113,000) |
| Decreases resulting from settlements with taxing authorities | |
| Reductions as a result of a lapse of the applicable statue of limitations | (61,000) |
| Balance at December 31, 2007 | $ 4,418,000 |

Of this total, $3,279,000 represents unrecognized tax benefits, net of federal tax benefit and accrued interest expense which, if recognized, would affect the Company s effective tax rate.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

Management anticipates that it is reasonably possible that the Company s total amount of unrecognized tax benefits will increase within the next twelve months by approximately $800,000 to $1,000,000 related to its ongoing California state tax apportionment factor issues.

The Company recognizes interest and penalties related to unrecognized tax benefits as a part of income taxes. During the years ended December 31, 2007, 2006, and 2005, the Company recognized interest and penalty expense of $450,000, $14,432,000, and $610,000, respectively. The Company carried an accrued interest balance of $710,000 and $260,000 at December 31, 2007 and 2006, respectively. No penalties have been expensed in 2007.

### (7) Reserves for Losses and Loss Adjustment Expenses

Activity in the reserves for losses and loss adjustment expenses is summarized as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| | (Amounts in thousands) | | |
| Gross reserves, beginning of year | $ 1,088,822 | $ 1,022,603 | $ 900,744 |
| Less reinsurance recoverable | (6,429) | (16,969) | (14,137) |
| Net reserves, beginning of year | 1,082,393 | 1,005,634 | 886,607 |
| Incurred losses and loss adjustment expenses related to: | | | |
| Current year | 2,017,120 | 2,000,357 | 1,909,453 |
| Prior years | 19,524 | 21,289 | (46,517) |
| Total incurred losses and loss adjustment expenses | 2,036,644 | 2,021,646 | 1,862,936 |
| Loss and loss adjustment expense payments related to: | | | |
| Current year | 1,345,234 | 1,311,982 | 1,218,784 |
| Prior years | 674,345 | 632,905 | 525,125 |
| Total payments | 2,019,579 | 1,944,887 | 1,743,909 |
| Net reserves, end of year | 1,099,458 | 1,082,393 | 1,005,634 |
| Reinsurance recoverable | 4,457 | 6,429 | 16,969 |
| Gross reserves, end of year | $ 1,103,915 | $ 1,088,822 | $ 1,022,603 |

The increase in the provision for insured events of prior years in 2007 primarily relates to adverse development of approximately $25 million in California mostly resulting from increases in estimates for loss severity and ultimate reported claims on the bodily injury reserves, which was partially offset by positive development of approximately $5 million related to operations outside of California. In October 2007, the Southern California region was devastated by sweeping fire storms. The Company recorded a pre-tax loss of approximately $23 million resulting from these fire storms.

The increase in the provision for insured events of prior years in 2006 relates largely to the unexpected development of several large extra-contractual claims in the state of Florida and increases in reserve estimates for the bodily injury and personal injury protection coverages in New Jersey.

The decrease in the provision for insured events of prior years in 2005 relates largely to a decrease in the estimated inflation rates on earlier accident years on bodily injury coverage for California automobile insurance.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

During 2005, the state of Florida was struck by several hurricanes. The pre-tax loss resulting from these hurricanes was approximately $27 million.

## (8) Shareholder Dividends and Dividend Restrictions

The following table summarizes shareholder dividends paid in total and per-share:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Total paid | $ 113,802,000 | $ 104,960,000 | $ 93,867,000 |
| Per-share | $2.08 | $1.92 | $1.72 |

The Insurance Companies are subject to the financial capacity guidelines established by their domiciliary states. The payment of dividends from statutory unassigned surplus of the Insurance Companies is restricted, subject to certain statutory limitations. For 2008, the direct insurance subsidiaries of the Company are permitted to pay approximately $246 million in dividends to the Company without the prior approval of the Department of Insurance ( DOI ) of the states of domicile. The above statutory regulations may have the effect of indirectly limiting the ability of the Company to pay shareholder dividends. During 2007 and 2006, the Insurance Companies paid dividends to Mercury General Corporation of $127.0 million and $168.0 million, respectively.

## (9) Statutory Balances and Accounting Practices

The Insurance Companies prepare their statutory financial statements in accordance with accounting practices prescribed or permitted by the various state insurance departments. Prescribed statutory accounting practices include primarily those published as statements of Statutory Accounting Principles by the National Association of Insurance Commissioners ( NAIC ), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. As of December 31, 2007, there were no material permitted statutory accounting practices utilized by the Insurance Companies.

The Insurance Companies statutory net income, as reported to regulatory authorities, was $237.3 million, $238.1 million and $253.8 million for 2007, 2006 and 2005, respectively. The statutory policyholders surplus of the Insurance Companies, as reported to regulatory authorities was $1,721.8 million and $1,579.2 million as of December 31, 2007 and 2006, respectively.

**(10) Commitments and Contingencies**

***Leases***

The Company is obligated under various noncancellable lease agreements providing for office space and equipment rental that expire at various dates through the year 2013. For leases that contain predetermined escalations of the minimum rentals, the Company recognizes the related rent expense on a straight-line basis and records the difference between the recognized rental expense and amounts payable under the leases as deferred rent in other liabilities. This liability amounted to approximately $1,200,000 and $1,000,000 at December 31, 2007 and 2006, respectively. Total rent expense under these lease agreements was $9,469,000, $8,292,000 and $7,175,000 for 2007, 2006 and 2005, respectively.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

The annual rental commitments, expressed in thousands, are shown as follows:

| Year | Rent Expense |
|---|---|
| 2008 | $ 9,889 |
| 2009 | 7,849 |
| 2010 | 6,387 |
| 2011 | 4,534 |
| 2012 | 3,098 |
| Thereafter | 1,411 |

***Litigation***

The Company is, from time to time, named as a defendant in various lawsuits relating to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages, which are not insurable under judicial decisions. The Company has established reserves for lawsuits in cases where the Company is able to estimate its potential exposure and it is probable that the court will rule against the Company. The Company vigorously defends actions against it, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may have a material impact on the Company s results of operations in the period of such ruling, however, it is not expected to be material to the Company s financial condition.

*Sam Donabedian, individually and on behalf of those similarly situated v. Mercury Insurance Company, et al.*, was originally filed on April 20, 2001 in the Los Angeles Superior Court, asserting, among other things, a claim that the Company s calculation of persistency discounts to determine premiums is an unfair business practice, a violation of the California Consumer Legal Remedies Act ( CLRA ) and a breach of the covenant of good faith and fair dealing. The Company originally prevailed on a Demurrer to the Complaint and the case was dismissed; however, the California Court of Appeal reversed the trial court s ruling, deciding that the California Insurance Commissioner does not have the exclusive right to review the calculation of insurance rates/premiums. After filing two additional pleadings, on June 28, 2005, the Plaintiff filed a Fourth Amended Complaint asserting claims for violation of California Business & Professions Code Section 17200 and breach of the covenant of good faith and fair dealing (the CLRA claim previously had been dismissed with prejudice). Plaintiff again sought injunctive relief, unspecified restitution and monetary damages as well as punitive damages and attorneys fees and costs. Without leave of court, the Plaintiff also attempted to state claims for breach of contract and fraud. The Company filed a Demurrer and Motion to Strike certain portions of the Plaintiff s Fourth Amended Complaint. Following a hearing on September 19, 2005, the Court took the matter under submission. While the motions were under submission, counsel for the Plaintiff asked the Company to engage in settlement discussions. The Court agreed to stay the matter and counsel for the Plaintiff and the Company met on several occasions to seek resolution, but none was reached.

Additionally, over the Company s objection, on May 9, 2005, the trial court permitted The Foundation for Taxpayer and Consumer Rights ( FTCR ) to file a Complaint in Intervention to allege that the Company s calculation of persistency discounts constitutes a violation of insurance Code Section 1861.02(a) and (c). Following a ruling by the Court of Appeal in another case which found that there is no private right of action to allege violations of Section 1861.02, the Company brought a motion for judgment on the pleadings to have FTCR s Complaint in Intervention dismissed. That motion was heard on April 28, 2006. Subsequent to the hearing, FTCR filed an amended complaint in intervention, and the Company again filed a motion for judgment on the pleadings, which the

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

Court denied at a hearing on July 31, 2006. In view of the then on-going settlement discussions with the Plaintiff, the Company did not seek further appellate review of the Court s ruling.

During the fall of 2005, counsel for the Plaintiff and the Company met on several occasions in an effort to resolve the case. FTCR was not invited to participate in these discussions. When Plaintiff and the Company were not able to reach a resolution, the Court ordered the parties to a settlement conference before another judge. On August 1, 2006, following three settlement conferences, the Company and the Plaintiff reached a preliminary settlement which was subject to completion of the class approval process and was also subject to objections and review by the Court. Prior to the hearing scheduled for October 30, 2006, the FTCR filed objections to the proposed settlement. Also, shortly before the hearing, the California DOI filed a letter with the Court contending that the terms of the settlement, which provided for a coupon to class members to be used toward the purchase of new, not renewal business, constituted a discount of insurance rates and thus would be subject to the California DOI s approval. Following several delays and further briefing by the parties, at a hearing on February 5, 2007, the Court declined to give preliminary approval to the proposed settlement. Accordingly, upon the Company s request, the tentative ruling on the Company s demurrer and motion to strike was unsealed. The Court sustained the Company s demurrer to all but the Section 17200 claim, as well as a claim for alleged violation of Insurance Code Section 1861.02 which the parties subsequently stipulated to dismiss. The Court also granted the Company s request to strike the punitive damage claim. On February 27, 2007, the Court determined, at the Company s request, that the Court would initially evaluate the Company s defenses that its conduct was protected by the administrative estoppel and filed rate plan doctrines and thus the Company has no liability in the case and established a schedule for discovery and briefing on these issues. Thereafter, the Company and Plaintiff continued settlement discussions and ultimately were able to reach an agreement which has preliminarily been approved by the Court. The settlement provides for the Company to issue coupons to class members (who do not opt out of the class) that can be used towards new or renewal business in a minimum aggregate amount of $5 million, and if coupons up to that amount are not redeemed, the difference will go to charities to be designated by the Court. The Company submitted the filing to the California DOI for approval and the terms of the settlement were approved by the California DOI in September 2007. Accordingly, the Company has mailed notice of the settlement to all class members who will then have a period of time to object or opt out of the settlement if they choose not to participate. A settlement was approved by the Court on December 14, 2007. The Court also considered FTCR s request for attorney s fees and took the matter under submission. Prior to the Court s ruling on the matter, the Plaintiff agreed to reduce its $1,575,000 in agreed upon fees by $250,000, payable to FTCR, and the Company agreed to give FTCR an additional $250,000 for a total payment of attorneys fees by the Company to Plaintiffs counsel of $1,325,000 and to counsel for FTCR of $500,000 with any additional fees claimed by FTCR to come from any monies that remain available in the guaranteed $5 million that the Company has committed in the settlement after redemption of coupons issued to class members. The agreed upon counsel fees have been accrued as of December 31, 2007. The judgment will be final on March 25, 2008 unless an appeal is taken.

Although the Company continues to believe that it has strong defenses to the action, given the California DOI s actions in connection with the Company s application of the persistency discount, the proposed settlement is believed to be a favorable outcome of the case considering the cost, inconvenience and uncertainty of litigation. The Company accrued $5 million as a reduction in premiums in the second quarter of 2007 related to the settlement of this case.

In *Marissa Goodman, on her own behalf and on behalf of all others similarly situated v. Mercury Insurance Company* (Los Angeles Superior Court), filed June 16, 2002, the Plaintiff is challenging the Company s use of certain automated database vendors to assist in valuing claims for medical payments. The Plaintiff filed a motion seeking class action certification to include all of the

Company  s insureds from 1998 to the present who presented

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

a medical payments claim, had the claim reduced using the computer program and whose claim did not reach the policy limits for medical payments. On January 11, 2007, the Court certified the requested class and class notice has been sent to approximately 14,000 class members. The Company has appealed the class certification ruling, and the Court of Appeal has stayed the case pending their review. The Plaintiff alleges that these automated databases systematically undervalue medical payment claims to the detriment of insureds. The Plaintiff is seeking actual and punitive damages. Similar lawsuits have been filed against other insurance carriers in the industry. The case has been coordinated with two other similar cases, and also with ten other cases relating to total loss claims. The Court denied the Company s Motion for Summary Judgment holding that there is an issue of fact as to whether Ms. Goodman sustained any damages as a result of the Company s handling of her medical payments claim. The Company and the Plaintiff have agreed to settle the claims for an amount that is immaterial to the Company s operations and financial position. The settlement is subject to review and approval by the Court. The Company expects the Court will approve the settlement. The ultimate outcome of this matter is not expected to be material to the Company s financial position.

On March 28, 2006, the California State Board of Equalization ( SBE ) upheld Notices of Proposed Assessments issued against the Company for tax years 1993 through 1996 in which the California Franchise Tax Board disallowed a portion of the Company s expenses related to management services provided to its insurance company subsidiaries. As a result of this ruling, the Company recorded an income tax charge (including penalties and interest) of approximately $15 million, after federal tax benefit, in the first quarter of 2006. On April 24, 2007, the Company filed a complaint in the Superior Court for the City and County of San Francisco challenging the SBE decision and seeking recovery of the taxes, penalties and interest paid by the Company as a result of the SBE decision. The trial has been scheduled for April 28, 2008. The Company believes that the deduction of the expenses related to management services provided to its insurance company subsidiaries is appropriate and intends to vigorously prosecute the case.

In *Robert Krumme, On Behalf Of The General Public v. Mercury Insurance Company, Mercury Casualty Company, and California Automobile Insurance Company* (Superior Court for the City and County of San Francisco), the Court issued a modified injunction on July 11, 2005 that, among other things, required the Company to accept applications for insurance from any California licensed broker with limited exceptions, restricted the use of broker manuals and communications with brokers by the Company s field personnel, and required the Company to compensate brokers at the same rate based on volume of sales. The Company has implemented changes to its operations and believes that it is in compliance with the modified injunction. At the time the injunction was issued, the Court stated that it would consider vacating the modified injunction following a one year period of review of the changes in the Company s operations. In March 2007, the Company filed a motion seeking to vacate the modified injunction. At the hearing, the Court ordered that counsel be permitted to conduct a further limited investigation and to file a report for further consideration by the Court. The Company is unable to determine whether the modified injunction will be vacated or estimate the impact of the Court s decision regarding the modified injunction on future trends in earnings or loss ratios.

The Company is also involved in proceedings relating to assessments and rulings made by the California Franchise Tax Board. See Note 6 of Notes to Consolidated Financial Statements.

**(11) Profit Sharing Plan**

The Company, at the option of the Board of Directors, may make annual contributions to an employee Profit Sharing Plan (the Plan ). The contributions are not to exceed the greater of the Company s net income for the plan year or its retained earnings at that date. In addition, the annual contributions may not exceed an amount equal to

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

15% of the compensation paid or accrued during the year to all participants under the Plan. The annual contribution was $1,900,000, $1,900,000 and $1,850,000 for 2007, 2006 and 2005, respectively.

The Plan includes an option for employees to make salary deferrals under Section 401(k) of the Internal Revenue Code. Company matching contributions, at a rate set by the Board of Directors, totaled $5,056,000, $4,512,000 and $3,861,000 for 2007, 2006 and 2005, respectively.

The Plan also includes an employee stock ownership plan ( ESOP ) that covers substantially all employees. The Board of Directors authorized the Plan to purchase $1.2 million of the Company s common stock in the open market for allocation to the Plan participants. The Company recognized $1,200,000, $1,200,000 and $1,100,000 as compensation expense in 2007, 2006 and 2005, respectively.

**(12) Share-Based Compensation**

In May 1995, the Company adopted the 1995 Equity Participation Plan (the 1995 Plan ) which succeeded a prior plan. In May 2005, the Company adopted the 2005 Equity Incentive Award Plan (the 2005 Plan ) which succeeds the 1995 Plan. Share-based compensation awards may only be granted under the 2005 Plan. A combined total of 5,400,000 shares of Common Stock under the 1995 Plan and the 2005 Plan are authorized for issuance upon exercise of options, stock appreciation rights and other awards, or upon vesting of restricted or deferred stock awards. The maximum number of shares that may be issued under the 2005 Plan is 5,400,000. As of December 31, 2007, only options and restricted stock awards have been granted under these plans. Options granted for which the Company has recognized share-based compensation expense generally become exercisable 20% per year beginning one year from the date granted, are granted at the market price on the date of grant, and expire after 10 years. During 2006, the Company granted restricted stock awards to an employee and subsequently cancelled the total shares following her resignation in the same year. The Company has no restricted stock outstanding as of December 31, 2007.

No share-based compensation was recognized in 2005. The following table presents net income and earnings per common share in 2005 as if the Company had recognized share-based compensation using the fair-value-based method:

| | **2005** |
|---|---|
| Net income, as reported | $ 253,259,000 |
| Deduct: Total share-based compensation determined under fair-value-based method for all awards, net of tax | (599,000) |

| | |
|---|---|
| Pro forma net income | $ 252,660,000 |
| | |
| Earnings per common share: | |
| Basic  as reported | $ 4.64 |
| Basic  pro forma | $ 4.63 |
| Diluted  as reported | $ 4.63 |
| Diluted  pro forma | $ 4.62 |

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits resulting from the exercise of stock options as cash provided by operating activities in the consolidated statements of cash flows. SFAS No. 123R requires the cash flows resulting from excess tax benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as cash provided by financing activities.

Cash received from option exercises during 2007, 2006 and 2005 was $2,173,000, $1,943,000 and $2,394,000, respectively. The excess tax benefit realized during 2007 and 2006 and the actual tax benefit realized during 2005 for the tax deduction from option exercises of the share-based payment awards totaled $273,000, $505,000 and $503,000, respectively.

The fair value of stock option awards was estimated using the Black-Scholes option pricing model with the following grant-date assumptions and weighted-average fair values:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| Weighted-average fair value of grants | $7.45 | $10.62 | $12.98 |
| Expected volatility | 17.87%-18.50% | 20.56%-24.22% | 26.44%-27.98% |
| Weighted-average expected volatility | 18.14% | 20.56% | 26.44% |
| Risk-free interest rate | 4.02%-4.91% | 4.54%-5.00% | 3.82%-4.31% |
| Expected dividend yield | 3.77%-4.13% | 3.41%-3.74% | 2.87%-3.11% |
| Expected term in months | 72 | 72 | 72 |

The risk free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant. The expected volatility on the date of grant is calculated based on historical volatility over the expected term of the options. The expected term computation is based on historical exercise patterns and post-vesting termination behavior.

A summary of the stock option activity of the Company s plans in 2007 is presented below:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (years) | Aggregate Intrinsic Value (in 000 s) |
|---|---|---|---|---|
| Outstanding at January 1, 2007 | 467,052 | $ 44.81 | | |
| Granted | 114,500 | 51.94 | | |
| Exercised | (60,307) | 36.04 | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Cancelled or expired | (44,000) | | 54.94 | | | |
| Outstanding at December 31, 2007 | 477,245 | $ | 46.70 | 6.2 | $ | 2,506 |
| Vested or expected to vest at December 31, 2007 | 477,245 | $ | 46.70 | 6.2 | $ | 2,506 |
| Exercisable at December 31, 2007 | 277,545 | $ | 42.06 | 4.4 | $ | 2,457 |

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007 and 2006**

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company s closing stock price and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all options been exercised on December 31, 2007. The aggregate intrinsic value of stock options exercised during 2007, 2006 and 2005 was $1,134,000, $1,661,000 and $2,780,000, respectively. The total fair value of options vested during 2007, 2006 and 2005 was $487,000, $886,000 and $827,000, respectively.

The following table summarizes information regarding stock options outstanding at December 31, 2007:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Number Outstanding** | **Weighted Avg. Remaining Contractual Life** | **Weighted Avg. Exercise Price** | **Number Exercisable** | **Weighted Avg. Exercise Price** |
| $21.75 to 29.77 | 27,245 | 2.3 | $ 25.31 | 27,245 | $ 25.31 |
| $31.22 to 58.83 | 450,000 | 6.4 | $ 47.99 | 250,300 | $ 43.88 |

As of December 31, 2007, $1,683,000 of total unrecognized compensation cost related to non-vested stock options is expected to be recognized over a weighted-average period of 2.2 years.

**(13) Earnings Per Share**

A reconciliation of the numerator and denominator used in the basic and diluted earnings per share calculation is presented below:

| | 2007 | | | 2006 | | | 2005 | | |
|---|---|---|---|---|---|---|---|---|---|
| | **(000 s) Income (Numerator)** | **(000 s) Weighted Shares (Denominator)** | **Per-Share Amount** | **(000 s) Income (Numerator)** | **(000 s) Weighted Shares (Denominator)** | **Per-Share Amount** | **(000 s) Income (Numerator)** | **(000 s) Weighted Shares (Denominator)** | **Per-Share Amount** |
| **Basic EPS** | | | | | | | | | |
| Income available to common stockholders | $ 237,832 | 54,704 | $ 4.35 | $ 214,817 | 54,651 | $ 3.93 | $ 253,259 | 54,566 | $ 4.64 |
| Effect of dilutive securities: | | | | | | | | | |
| Options | | 125 | | | 135 | | | 151 | |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Diluted EPS** | | | | | | | | | | | |
| Income available to common stockholders after assumed conversions | $ 237,832 | 54,829 | $ | 4.34 | $ 214,817 | 54,786 | $ | 3.92 | $ 253,259 | 54,717 | $ 4.63 |

The diluted weighted shares excludes incremental shares of 88,000, 107,000 and 19,000 for 2007, 2006 and 2005, respectively. These shares are excluded due to their antidilutive effect.

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company s reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and the Company s Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective at the reasonable assurance level.

**Changes in Internal Control over Financial Reporting**

There has been no change in the Company s internal control over financial reporting during the Company s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting. The Company s process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

**Management s Report on Internal Control over Financial Reporting**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control system was designed to provide reasonable assurance to the Company s management and board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. Based upon its assessment, the Company s management believes that, as of December 31, 2007, the Company s internal control over financial reporting is effective based on these criteria.

The Company s independent auditors have issued an audit report on the effectiveness of the Company s internal control over financial reporting. This report appears on page 56.

**Item 9B. Other Information**

None.

## PART III

**Item 10. Directors and Executive Officers of the Registrant**

**Item 11. Executive Compensation**

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

**Item 13. Certain Relationships and Related Transactions**

**Item 14. Principal Accounting Fees and Services**

Information regarding executive officers of the Company is included in Part I. For information called for by Items 10, 11, 12, 13 and 14 reference is made to the Company s definitive proxy statement for its Annual Meeting of Shareholders, to be held on May 14, 2008, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

## PART IV

**Item 15. Exhibits, Financial Statement Schedules**

(a) The following documents are filed as a part of this report:

1. Financial Statements: The Consolidated Financial Statements for the year ended December 31, 2007 are contained herein as listed in the Index to Consolidated Financial Statements on page 54.

2. Financial Statement Schedules:

**Title**

Report of Independent Registered Public Accounting Firm

Schedule I Summary of Investments Other than Investments in Related Parties

Schedule II Condensed Financial Information of Registrant

Schedule IV Reinsurance

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or Notes thereto.

3. Exhibits

| | |
|---|---|
| 3.1(1) | Articles of Incorporation of the Company, as amended to date. |
| 3.2(2) | Amended and Restated Bylaws of the Company. |
| 4.1(3) | Shareholders Agreement dated as of October 7, 1985 among the Company, George Joseph and Gloria Joseph. |
| 4.2(4) | Indenture between the Company and Bank One Trust Company, N.A., as Trustee dated as of June 1, 2001. |
| 4.3(5) | Officers Certificate establishing the Company s 7.25% Senior Notes due 2011 as a series of securities under the Indenture dated as of June 1, 2001 between Mercury General Corporation and Bank One Trust Company, N.A. |
| 10.1(1) | Form of Agency Contract. |
| 10.2(6)* | Profit Sharing Plan, as Amended and Restated as of March 11, 1994. |
| 10.3(7)* | Amendment 1994-I to the Mercury General Corporation Profit Sharing Plan. |

| | |
|---|---|
| 10.4(7)* | Amendment 1994-II to the Mercury General Corporation Profit Sharing Plan. |
| 10.5(8)* | Amendment 1996-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.6(8)* | Amendment 1997-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.7(1)* | Amendment 1998-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.8(9)* | Amendment 1999-I and Amendment 1999-II to the Mercury General Corporation Profit Sharing Plan. |
| 10.9(12)* | Amendment 2001-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.10(13)* | Amendment 2002-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.11(13)* | Amendment 2002-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.12(16)* | Amendment 2003-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.13(16)* | Amendment 2004-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.14* | Amendment 2006-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.15(20)* | Amendment 2006-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.16* | Amendment 2007-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.17(10)* | The 1995 Equity Participation Plan. |
| 10.18(11) | Management agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Casualty Company, Mercury Insurance Company, California Automobile Insurance Company and California General Underwriters Insurance Company. |
| 10.19(11) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and American Mercury Insurance Company. |
| 10.20(11) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Georgia. |
| 10.21(11) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Georgia. |
| 10.22(11) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Illinois. |
| 10.23(11) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Illinois. |
| 10.24(12) | Management Agreement effective January 1, 2002 between Mercury Insurance Services, LLC and Mercury Insurance Company of Florida and Mercury Indemnity Company of Florida. |
| 10.25(20) | Management Agreement dated January 22, 1997 between Mercury County Mutual Insurance Company (formerly known as Elm County Mutual Insurance Company and Vesta County Mutual Insurance Company) and Mercury Insurance Services, LLC (as successor in interest). |
| 10.26(14)* | Director Compensation Arrangements. |
| 10.27(15)* | Mercury General Corporation Senior Executive Incentive Bonus Plan. |
| 10.28(17)* | Mercury General Corporation 2005 Equity Incentive Award Plan. |
| 10.29(18)* | Incentive Stock Option Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan. |
| 10.30(19)* | Restricted Stock Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan. |
| 21.1(20) | Subsidiaries of the Company. |
| 23.1 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of Registrant s Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |

| | |
|---|---|
| 31.2 | Certification of Registrant s Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Registrant s Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company. |
| 32.2 | Certification of Registrant s Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company. |

(1) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.

(2) This document was filed as an exhibit to Registrant s Form 10-Q for the quarterly period ended September 30, 2007, and is incorporated herein by this reference

(3) This document was filed as an exhibit to Registrant s Registration Statement on Form S-1, File No. 33-899, and is incorporated herein by this reference.

(4) This document was filed as an exhibit to Registrant s Form S-3 filed with the Securities and Exchange Commission on June 4, 2001, and is incorporated herein by this reference.

(5) This document was filed as an exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on August 6, 2001, and is incorporated herein by this reference.

(6) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 1993, and is incorporated herein by this reference.

(7) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference.

(8) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.

(9) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.

(10) This document was filed as an exhibit to Registrant s Form S-8 filed with the Securities and Exchange Commission on March 8, 1996, and is incorporated herein by this reference.

(11) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

(12) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.

(13) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.

(14) This document was filed as an exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on February 3, 2005, and is incorporated herein by this reference.

(15) This document was filed as an exhibit to the Company s Definitive Proxy Statement on Schedule 14A (File No. 001-12257) filed with the Securities and Exchange Commission on April 8, 2003.

(16) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.

(17) This document was filed as an exhibit to the Company s Definitive Proxy Statement on Schedule 14A (File No. 001-12257) filed with the Securities and Exchange Commission on April 5, 2005.

(18) This document was filed as an exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on February 13, 2008, and is incorporated herein by this reference.

(19) This document was filed as an exhibit to Registrant s Form 10-Q for the quarterly period ended March 31, 2006, and is incorporated herein by this reference.

(20) This document was filed as an exhibit to Registrant s Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.

* Denotes management contract or compensatory plan or arrangement.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MERCURY GENERAL CORPORATION

By /s/ GABRIEL TIRADOR

**Gabriel Tirador**
**President and Chief Executive Officer**

February 25, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ GEORGE JOSEPH<br>**George Joseph** | Chairman of the Board | February 25, 2008 |
| /s/ GABRIEL TIRADOR<br>**Gabriel Tirador** | President and Chief Executive Officer and Director (Principal Executive Officer) | February 25, 2008 |
| /s/ THEODORE R. STALICK<br>**Theodore R. Stalick** | Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | February 25, 2008 |
| /s/ NATHAN BESSIN<br>**Nathan Bessin** | Director | February 25, 2008 |
| /s/ BRUCE A. BUNNER<br>**Bruce A. Bunner** | Director | February 25, 2008 |
| /s/ MICHAEL D. CURTIUS<br>**Michael D. Curtius** | Director | February 25, 2008 |
| /s/ RICHARD E. GRAYSON<br>**Richard E. Grayson** | Director | February 25, 2008 |

| | | |
|---|---|---|
| /s/ CHARLES MCCLUNG | Director | February 25, 2008 |
| **Charles McClung** | | |
| /s/ DONALD P. NEWELL | Director | February 25, 2008 |
| **Donald P. Newell** | | |
| /s/ DONALD R. SPUEHLER | Director | February 25, 2008 |
| **Donald R. Spuehler** | | |

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors

Mercury General Corporation:

Under date of February 25, 2008, we reported on the consolidated balance sheets of Mercury General Corporation and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2007, as contained in the annual report on Form 10-K for the year 2007. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedules as listed under Item 15(a)2. These financial statement schedules are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statement schedules based on our audits.

In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Los Angeles, California

February 25, 2008

**SCHEDULE I**

**MERCURY GENERAL CORPORATION**

**SUMMARY OF INVESTMENTS**

**OTHER THAN INVESTMENTS IN RELATED PARTIES**

**December 31, 2007**

| Type of Investment | Cost | Value | Amount at which shown in the balance sheet |
|---|---|---|---|
| | Amounts in thousands | | |
| Fixed maturities: | | | |
| Bonds: | | | |
| U.S. government | $ 36,157 | $ 36,375 | $ 36,375 |
| States, municipalities | 2,435,216 | 2,464,542 | 2,464,542 |
| Corporate bonds | 141,272 | 138,700 | 138,700 |
| Mortgage-backed securities | 245,731 | 246,072 | 246,072 |
| Redeemable preferred stock | 2,079 | 2,071 | 2,071 |
| Total fixed maturities | 2,860,455 | 2,887,760 | 2,887,760 |
| Equity securities: | | | |
| Common stocks: | | | |
| Public utilities | 35,703 | 66,175 | 66,175 |
| Banks, trust and insurance companies | 20,284 | 21,371 | 21,371 |
| Industrial, miscellaneous and all other | 245,095 | 313,035 | 313,035 |
| Nonredeemable preferred stocks | 29,913 | 27,656 | 27,656 |
| Total equity securities | 330,995 | 428,237 | 428,237 |
| Short-term investments | 272,678 | | 272,678 |
| Total investments | $ 3,464,128 | | $ 3,588,675 |

**SCHEDULE I**

**MERCURY GENERAL CORPORATION**

**SUMMARY OF INVESTMENTS**

**OTHER THAN INVESTMENTS IN RELATED PARTIES (Continued)**

**December 31, 2006**

| Type of Investment | Cost | Value | Amount at which shown in the balance sheet |
|---|---|---|---|
| | Amounts in thousands | | |
| Fixed maturities: | | | |
| Bonds: | | | |
| U.S. government | $ 133,733 | $ 132,477 | $ 132,477 |
| States, municipalities | 2,282,877 | 2,335,962 | 2,335,962 |
| Corporate bonds | 157,893 | 155,049 | 155,049 |
| Mortgage-backed securities | 273,420 | 271,733 | 271,733 |
| Redeemable preferred stock | 3,792 | 3,766 | 3,766 |
| Total fixed maturities | 2,851,715 | 2,898,987 | 2,898,987 |
| Equity securities: | | | |
| Common stocks: | | | |
| Public utilities | 123,289 | 171,319 | 171,319 |
| Banks, trust and insurance companies | 9,731 | 11,996 | 11,996 |
| Industrial, miscellaneous and all other | 77,222 | 85,466 | 85,466 |
| Nonredeemable preferred stocks | 48,068 | 49,668 | 49,668 |
| Total equity securities | 258,310 | 318,449 | 318,449 |
| Short-term investments | 282,302 | | 282,302 |
| Total investments | $ 3,392,327 | | $ 3,499,738 |

**SCHEDULE II**

**MERCURY GENERAL CORPORATION**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**BALANCE SHEETS**

**December 31,**

| | 2007 | 2006 |
|---|---|---|
| | Amounts in thousands | |
| **ASSETS** | | |
| Investments: | | |
| Fixed maturities available for sale, at fair value (amortized cost $961 in 2007 and $1,297 in 2006) | $ 987 | $ 1,338 |
| Equity securities available for sale, at fair value (cost $17,716 in 2007 and $12,668 in 2006) | 20,121 | 14,933 |
| Equity securities trading, at fair value (cost $6,282 in 2007) | 7,233 | |
| Short-term investments, at cost, which approximates fair value | 37,776 | 45,007 |
| Investment in subsidiaries | 1,915,871 | 1,772,607 |
| Total investments | 1,981,988 | 1,833,885 |
| Cash | 3,072 | 5,489 |
| Amounts receivable from affiliates | 514 | 464 |
| Income taxes | 8,895 | 26,865 |
| Other assets | 11,074 | 6,282 |
| Total assets | $ 2,005,543 | $ 1,872,985 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Notes payable | $ 134,062 | $ 130,304 |
| Accounts payable and accrued expenses | 3,732 | 3,090 |
| Other liabilities | 5,751 | 15,461 |
| Total liabilities | 143,545 | 148,855 |
| Shareholders equity: | | |
| Common stock | 69,369 | 66,436 |
| Accumulated other comprehensive income | 80,557 | 69,652 |
| Retained earnings | 1,712,072 | 1,588,042 |
| Total shareholders equity | 1,861,998 | 1,724,130 |
| Total liabilities and shareholders equity | $ 2,005,543 | $ 1,872,985 |

See accompanying notes to condensed financial information.

**SCHEDULE II**

**MERCURY GENERAL CORPORATION**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (Continued)**

**STATEMENTS OF INCOME**

**Three years ended December 31,**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| | Amounts in thousands | | |
| Revenues: | | | |
| Net investment income | $ 2,813 | $ 1,860 | $ 1,914 |
| Other | (3,147) | (1,336) | 1,600 |
| Total revenues | (334) | 524 | 3,514 |
| Expenses: | | | |
| Other operating expenses | 4,209 | 3,586 | 2,905 |
| Interest | 8,171 | 8,423 | 6,717 |
| Total expenses | 12,380 | 12,009 | 9,622 |
| Loss before income taxes and equity in net income of subsidiaries | (12,714) | (11,485) | (6,108) |
| Income tax (benefit) expense | (2,356) | 10,536 | (609) |
| Loss before equity in net income of subsidiaries | (10,358) | (22,021) | (5,499) |
| Equity in net income of subsidiaries | 248,190 | 236,838 | 258,758 |
| Net income | $ 237,832 | $ 214,817 | $ 253,259 |

See accompanying notes to condensed financial information.

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**SCHEDULE II**

**MERCURY GENERAL CORPORATION**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (Continued)**

**STATEMENTS OF CASH FLOWS**

**Three years ended December 31,**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| | | Amounts in thousands | |
| Cash flows from operating activities: | | | |
| Net cash used in operating activities | $ (9,627) | $ (10,733) | $ (27,400) |
| Cash flows from investing activities: | | | |
| Capital contribution to controlled entities | (11,250) | (20,000) | (15,000) |
| Dividends from subsidiaries | 127,000 | 168,000 | 134,000 |
| Fixed maturities available for sale: | | | |
| Purchases | | (9) | |
| Sales | | 333 | |
| Calls or maturities | 353 | | 303 |
| Equity securities available for sale: | | | |
| Purchases | (52,121) | (73,310) | (85,445) |
| Sales | 47,764 | 72,469 | 87,849 |
| Decrease in payable for securities, net | (204) | (254) | |
| Net decrease (increase) in short-term investments | 7,231 | (31,901) | (639) |
| Other, net | (207) | 18 | 17 |
| Net cash provided by investing activities | 118,566 | 115,346 | 121,085 |
| Cash flows from financing activities: | | | |
| Dividends paid to shareholders | (113,802) | (104,960) | (93,866) |
| Stock options exercised | 2,173 | 1,943 | 2,393 |
| Excess tax benefit from exercise of stock options | 273 | 505 | |
| Net cash used in financing activities | (111,356) | (102,512) | (91,473) |
| Net (decrease) increase in cash | (2,417) | 2,101 | 2,212 |
| Cash: | | | |
| Beginning of the year | 5,489 | 3,388 | 1,176 |
| End of the year | $ 3,072 | $ 5,489 | $ 3,388 |

See accompanying notes to condensed financial information.

**SCHEDULE II**

**MERCURY GENERAL CORPORATION**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (Continued)**

**NOTES TO CONDENSED FINANCIAL INFORMATION**

**December 31, 2007 and 2006**

The accompanying condensed financial information should be read in conjunction with the consolidated financial statements and notes included in this statement.

**Reclassifications**

Certain reclassifications have been made to prior year balances to conform to the current year presentation.

**Dividends Received From Subsidiaries**

Dividends of $127,000,000, $168,000,000 and $134,000,000 were received by the Company from its wholly-owned subsidiaries in 2007, 2006 and 2005, respectively, and are recorded as a reduction to investment in subsidiaries.

**Capitalization of Subsidiaries**

Capital contributions of $11,250,000 and $20,000,000 were made by the Company to its insurance subsidiaries during 2007 and 2006, respectively.

**Federal Income Taxes**

The Company files a consolidated federal tax return with the following entities:

Mercury Casualty Company

Mercury Insurance Company

California General Underwriters Insurance Company, Inc.

California Automobile Insurance Company

Mercury Insurance Company of Illinois

Mercury National Insurance Company

Mercury Insurance Company of Georgia

Mercury Indemnity Company of Georgia

American Mercury Insurance Company

Mercury Select Management Company, Inc.

American Mercury Lloyds Insurance Company

American Mercury MGA, Inc.

Concord Insurance Services, Inc.

Mercury County Mutual Insurance Company

Mercury Insurance Company of Florida

Mercury Indemnity Company of America

Mercury Group, Inc.

The method of allocation between the companies is subject to agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses incurred by the insurance subsidiaries to the extent it can be used in the current consolidated return.

**SCHEDULE IV**

**MERCURY GENERAL CORPORATION**

**REINSURANCE**

**Three years ended December 31,**

| | Direct amount | Ceded to other companies | Assumed | Net amount |
|---|---|---|---|---|
| | | Amounts in thousands | | |
| Property and Liability insurance earned premiums | | | | |
| 2007 | $ 2,996,927 | $ 4,119 | $ 1,069 | $ 2,993,877 |
| 2006 | $ 3,007,007 | $ 11,092 | $ 1,108 | $ 2,997,023 |
| 2005 | $ 2,856,598 | $ 10,085 | $ 1,220 | $ 2,847,733 |

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