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**Horace Mann Educators Corporation**  
**2005 Annual Report and 10-K**

1-10890



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**Horace Mann**<sup>®</sup>  
Educated Financial Solutions

## Financial Highlights

(Dollars in millions, except per share data)

| Year Ended December 31,                             | 2005       | 2004       | 2003       |
|---|------------|------------|------------|
| <b>Operations</b>                                   |            |            |            |
| Insurance premiums written and contract deposits    | \$ 972.6   | \$ 998.4   | \$ 955.5   |
| Net income  | 77.3       | 56.3       | 19.0       |
| Return on equity (1)                                | 13.2%      | 10.3%      | 3.5%       |
| Property & casualty combined loss and expense ratio | 95.6%      | 100.5%     | 112.3%     |
| Experienced agents                                  | 600        | 539        | 510        |
| Financed agents                                     | 255        | 261        | 378        |
| Total career agents                                 | 855        | 800        | 888        |
| <b>Per share</b>                                    |            |            |            |
| Net income per share:                               |            |            |            |
| Basic   | \$ 1.80    | \$ 1.32    | \$ 0.44    |
| Diluted   | \$ 1.67    | \$ 1.25    | \$ 0.44    |
| Dividends paid                                      | \$ 0.42    | \$ 0.42    | \$ 0.42    |
| Book value (2)                                      | \$ 13.51   | \$ 13.45   | \$ 12.42   |
| <b>Financial position</b>                           |            |            |            |
| Total assets  | \$ 5,840.6 | \$ 5,371.9 | \$ 4,953.2 |
| Short-term debt                                     | —          | 25.0       | 25.0       |
| Long-term debt                                      | 190.9      | 144.7      | 144.7      |
| Total shareholders' equity                          | 580.6      | 576.2      | 530.5      |

(1) Based on 12-month net income and average quarter-end shareholders' equity.

(2) Before the fair value adjustment for investments, book value per share was \$12.85 at December 31, 2005, \$11.45 at December 31, 2004 and \$10.51 at December 31, 2003.

### Forward-looking information

It is important to note that the Company's actual results could differ materially from those projected in forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained from time to time in the Company's SEC filings. Copies of these filings may be obtained by contacting the Company or the SEC.

## Letter to Shareholders

Horace Mann viewed 2005 as an opportunistic year in which we could increase our value to shareholders while continuing to reinforce our commitment to clients through our Value Proposition. Our company is well positioned to be recognized across the nation as *the educator expert* in our industry.

By seizing on the operational momentum of 2004, we delivered additional franchise value to our shareholders. For our educator clients, we delivered a unique mix of products, services, benefits and features that we believe compares with no other company.

In 2005, we achieved full-year earnings per share of \$1.67 – even after absorbing losses from our second worst catastrophe year on record – and a return on equity of 13.2 percent, an improvement of nearly three percentage points over the prior year.

We enjoyed these results thanks to our ability to post strong property and casualty profit margins while maintaining appropriate reserve levels, quality and diversification in our investment portfolio, and a focus on expenses that helped keep operating costs consistent with expectations.

Because of the progress made in recent years to restore profitability, strengthen our financial foundation and improve operations, our core strategy over the short and long terms emphasizes strengthening our distribution power and further distinguishing Horace Mann from our competitors through differentiation.

**Auto production, agent growth strengthen our distribution power**  
Auto insurance has been the primary catalyst of Horace Mann's success since two teachers seeking to provide affordable coverage to their peers founded

our company 60 years ago. And 2005 was no exception, as we reemphasized auto's importance to our agents as the enabler that drives sales productivity and revenue.

Our recently instituted Value-Based Solutions (VBS) selling process reinforces auto's role in both growing our business and taking the first step in developing a lifelong relationship with a client. VBS focuses on value and competitiveness, emphasizing the unique benefits we offer our clients. We also designed VBS to work hand-in-hand with our established *Solutions* software for life and annuity sales support.

With VBS forming the foundation for greater agent success in auto, we're preparing to transition more agents away from home-based, one-person operations and toward a more sophisticated distribution channel that makes greater use of outside offices and licensed support staff.

We took the first step toward this migration by establishing a new agent compensation plan that increases rewards for agents who sell more new auto business and sustain their renewal book of business. The new plan provides agents with a more predictable cash flow from renewals to invest in their operations. Additionally, we geared many of our marketing campaigns and internal promotions to spur increased interest in auto, both with our agents and our target market.

We also introduced our new Educator Segmentation Model (ESM) in the first two states – Virginia and Colorado. ESM provides a more precise approach to pricing auto business through expanded rating factors, including a greater number of preferred rates for educators. Already, ESM has contributed to increased sales and retention where it has been implemented.

Countrywide, these programs and initiatives contributed to increasing levels of both auto new business and retention as the year progressed. After a slow start to 2005, new auto sales units improved steadily and by third quarter began exceeding 2004 results.

We also made strides in bolstering our distribution power as our agency force grew from quarter to quarter and agent retention continued to improve, resulting in a year-end total of 855 career agents, up 7 percent over prior year.

**Market differentiators set us apart**  
As we boost the distribution power of our agency force, our initiatives for enhancing and expanding the most valuable elements of the Horace Mann experience are distinguishing us from the competition.

Ongoing property and casualty enhancements, for example, focus on what we bring to educators:

- Our innovative tri-line discounts provide our clients the best opportunity to save when they consolidate their insurance with Horace Mann.
- The Educator Segmentation Model is used to not only price auto risks appropriately but also price specifically for our target market.
- Our Product Management Organization enlists product experts to take advantage of localized approaches to pricing, underwriting and marketing for developing new business growth opportunities.

At the same time, we are pursuing a multi-tiered strategy to increase our exposure within the educator marketplace by strengthening and further establishing the Horace Mann brand:

- We developed the Lincoln Fellowships in partnership with the Abraham Lincoln Presidential Library and Museum, so educators can share their knowledge and world-class experience with students about one of our nation's greatest presidents.
- We're developing a comprehensive plan to further define and communicate our brand essence that further differentiates Horace Mann with educators.
- Our market research initiatives, which include a virtual educator advisory board, are elevating our position as the educator company while helping us better identify the unique needs of our clients.

Other market differentiators rising from service improvements and enhancements include our expanded call center hours that give educators more convenient access to our service representatives. Additionally, our new mobile claim offices bring adjusters directly to the client, settling claims and issuing checks at the client's school.

**Claims service advances mitigate impact of catastrophes**  
Delivering world-class claims service while achieving operational efficiencies continues to be paramount especially in the face of catastrophes. Despite the enormous challenges presented by hurricanes Katrina, Rita and Wilma, our claims employees continued to excel in handling each claim with care, diligence and empathy for our clients.

From an industry perspective, 2005 was unprecedented in terms of the magnitude of catastrophe damage impacting insurers and their customers. For Horace Mann, we experienced our

second costliest catastrophe year on record. While circumstances have made claims processing a daunting task to say the least, we closed over 95 percent of reported claims from both Katrina and Rita by year-end.

Ongoing improvements in claims processes and cost containment initiatives, as well as service advances resulting from previous years' upgrading of our claims software, technology and practices, helped control loss severities while reducing claim settlement expenses.

Going into 2006, we will capitalize on our claims processing advances to further minimize costs and increase customer satisfaction levels. New initiatives include Claims Desktop, which more efficiently processes claims and delivers an even sharper focus on customer service. In light of recent catastrophic events, we've also strengthened our reinsurance program to provide increases in both single-event and aggregate coverage, and we are continuing with our strategy to further limit our coastal exposure.

### Meeting challenges of multiple business lines

Looking beyond catastrophes, our underlying auto and homeowners results continue to benefit from previous years' pricing, underwriting and cost containment initiatives. While these factors contributed to reductions in property and casualty premiums written and policies in force, the proportion of educator policies in force is rising steadily and the quality of both new and in-force business continues to improve.

We anticipate further gains in auto and homeowners production in 2006, particularly from educator business, as our initiatives to improve the agents' ease

of doing business gain traction and our Educator Segmentation Model and Product Management Organization are introduced in more states.

Annuity sales declined compared to the record pace of 2004, which was in line with industry trends. Life sales were also somewhat below expectations.

Annuity sales were down from prior year. The decline was attributed to a number of factors, including fewer single premium and rollover deposits and a challenging interest rate environment that continued to impact the industry as a whole. Despite the downturn in sales, performance in the annuity segment remained strong. Total assets under management and periodic premium sales – the heart and soul of the 403(b) annuity market – continued to show healthy, sequential growth.

We look forward to reinvigorating our life and annuity sales with the introduction of new products early in 2006. Our *Life by Design* permanent and term life policies will be the catalyst for growth in the life segment. Our new fixed interest annuity, *Expanding Horizon*, and variable annuity, *Goal Planning Annuity* (GPA), will provide our agents with new, innovative products to attract a greater audience within the educator market.

*Expanding Horizon* offers two new fixed annuity options for conservatively minded customers and offers a choice of surrender charge and bonus combinations. The GPA features our new *Life Cycle* investment options, developed in partnership with our funds advisor, Wilshire Associates, to help tailor clients' retirement plans as their life circumstances change.

## Capitalizing our brand potential

In 2006, Horace Mann is poised to increase our distribution power and more fully differentiate ourselves in the marketplace. This, in turn, will help make our Value Proposition more compelling to a greater number of educator customers.

With new products, and with auto production driving cross-selling opportunities, our "Driving All Lines" marketing campaign will vigorously address business growth while we continue to maintain profitable margins and balance sheet strength. Auto production will remain critical to our steady migration toward a more professional and robust agent business model.

We will continue to push auto growth and profitability on several fronts, including:

- The delivery of our Educator Segmentation Model to 12-15 more states by year-end;
- The continuation of process improvements that make it easier for agents to write auto business; and
- The installation of a new property and casualty front-end system to dramatically improve the process of writing new business for our agents and clients.

With the availability of new life and annuity product offerings, we see our agents capitalizing more on the cross-selling opportunities auto creates to drive growth in these two critical lines of business.

Expansion of our market differentiation strategies will be another priority in 2006, whether it's through newer initiatives like our Young Educator Program, designed to deliver our Value Proposition to a new generation of educators through a series of value-added benefits, or our longstanding endorsements such as with the National Education Association (NEA) and its affiliates.

From a fiscal standpoint, we'll continue to make progress on strengthening our internal controls, having successfully remediated two Section 404 material weaknesses that we reported last year.

Our employees are the constant for all these initiatives. Their outstanding everyday performance resonates with our client base and other stakeholders, as everybody at Horace Mann remains committed to delivering a combination of superior products, benefits and services to the educator market.

We see 2006 as a tremendous step forward in enhancing the delivery of our Value Proposition to improve client access, attract more prospects and retain more policyholders. In doing so, we will further build the value of the Horace Mann franchise.



**Joseph J. Melone**  
Chairman of  
the Board of Directors



**Louis G. Lower II**  
President &  
Chief Executive  
Officer

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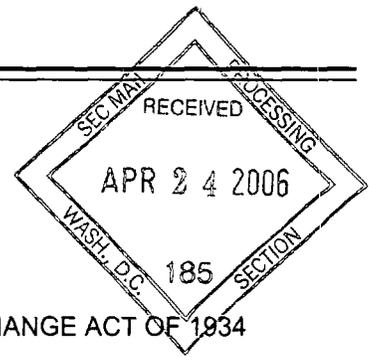


**Joseph J. Melone**  
Chairman of  
the Board of Directors



**Louis G. Lower II**  
President &  
Chief Executive  
Officer

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549



**FORM 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 2005**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-10890

**HORACE MANN EDUCATORS CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

37-0911756

(I.R.S. Employer Identification No.)

1 Horace Mann Plaza, Springfield, Illinois 62715-0001

(Address of principal executive offices, including Zip Code)

Registrant's Telephone Number, Including Area Code: 217-789-2500

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock, par value \$0.001 per share

Name of each exchange on which registered  
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark the registrant's filer status, as such terms are defined in Rule 12b-2 of the Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company, as defined in Rule 12b-2 of the Act. Yes  No

The aggregate market value of the registrant's voting Common Stock held by non-affiliates of the registrant based on the closing price of the registrant's Common Stock on the New York Stock Exchange and the shares outstanding on June 30, 2005, was \$807.3 million.

As of February 28, 2006, 42,989,389 shares of the registrant's Common Stock, par value \$0.001 per share, were outstanding, net of 17,503,371 shares of treasury stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain portions of the registrant's Proxy Statement for the 2006 Annual Meeting of Shareholders are incorporated by reference into Part II Item 5 and Part III Items 10, 11, 12, 13 and 14 of Form 10-K as specified in those Items and will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005.

**HORACE MANN EDUCATORS CORPORATION**  
**FORM 10-K**  
**YEAR ENDED DECEMBER 31, 2005**

**INDEX**

| <u>Part</u> | <u>Item</u>  | <u>Page</u> |
|-------------|--|-------------|
| I           | 1. Business .....  | 1           |
|             | Forward-looking Information.....   | 1           |
|             | Overview and Available Information.....  | 1           |
|             | History.....   | 2           |
|             | Selected Historical Consolidated Financial Data.....   | 3           |
|             | Corporate Strategy and Marketing.....  | 4           |
|             | Property and Casualty Segment.....   | 6           |
|             | Annuity Segment .....  | 16          |
|             | Life Segment.....  | 18          |
|             | Investments .....  | 19          |
|             | Cash Flow.....   | 22          |
|             | Competition.....   | 22          |
|             | Regulation.....  | 23          |
|             | Employees.....   | 24          |
|             | 1A. Risk Factors.....  | 25          |
|             | 1B. Unresolved Staff Comments.....   | 34          |
|             | 2. Properties .....  | 34          |
|             | 3. Legal Proceedings .....   | 34          |
|             | 4. Submission of Matters to a Vote of Security Holders.....  | 34          |
| II          | 5. Market for Registrant's Common Equity, Related Stockholder<br>Matters and Issuer Purchases of Equity Securities ..... | 35          |
|             | 6. Selected Financial Data.....  | 35          |
|             | 7. Management's Discussion and Analysis of Financial Condition and<br>Results of Operations.....                         | 35          |
|             | 7A. Quantitative and Qualitative Disclosures About Market Risk .....   | 36          |
|             | 8. Consolidated Financial Statements and Supplementary Data .....  | 36          |
|             | 9. Changes in and Disagreements with Accountants on<br>Accounting and Financial Disclosure.....                          | 36          |
|             | 9A. Controls and Procedures .....  | 36          |
|             | 9B. Other Information .....  | 39          |
| III         | 10. Directors and Executive Officers of the Registrant .....   | 39          |
|             | 11. Executive Compensation .....   | 39          |
|             | 12. Security Ownership of Certain Beneficial Owners and Management<br>and Related Stockholder Matters.....               | 40          |
|             | 13. Certain Relationships and Related Transactions .....   | 40          |
|             | 14. Principal Accounting Fees and Services.....  | 40          |
| IV          | 15. Exhibits and Financial Statement Schedules.....  | 40          |
|             | Signatures .....   | 46          |
|             | Index to Financial Information.....  | F-1         |

## PART I

### ITEM 1. Business

#### Forward-looking Information

It is important to note that the Company's actual results could differ materially from those projected in forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations".

#### Overview and Available Information

Horace Mann Educators Corporation ("HMEC"; and together with its subsidiaries, the "Company" or "Horace Mann") is an insurance holding company incorporated in Delaware. Through its subsidiaries, HMEC markets and underwrites personal lines of property and casualty and life insurance and retirement annuities in the United States of America ("U.S."). HMEC's principal insurance subsidiaries are Horace Mann Insurance Company ("HMIC"), Teachers Insurance Company ("TIC") and Horace Mann Life Insurance Company ("HMLIC"), each of which is an Illinois corporation; Horace Mann Property & Casualty Insurance Company ("HMPCIC"), a California corporation; and Horace Mann Lloyds ("HM Lloyds"), an insurance company domiciled in Texas.

The Company markets its products primarily to educators and other employees of public schools and their families. The Company's nearly one million customers typically have moderate annual incomes, with many belonging to two-income households. Their financial planning tends to focus on retirement, security, savings and primary insurance needs. Management believes that Horace Mann is the largest national multiline insurance company focused on the nation's educators as its primary market.

The Company markets and services its products primarily through an exclusive sales force of full-time agents employed by the Company and trained to sell multiline products. The Company's agents sell Horace Mann's products and limited additional third-party vendor products authorized by the Company. Many of the Company's agents are former educators or individuals with close ties to the educational community who utilize their contacts within, and knowledge of, the target market. Compensation for agents includes an incentive element based upon the profitability of the business they write. This employee agent sales force is supplemented by an independent agent distribution channel for the Company's annuity products.

The Company's insurance premiums written and contract deposits for the year ended December 31, 2005 were \$972.6 million and net income was \$77.3 million. The Company's total assets were \$5.8 billion at December 31, 2005. The property and casualty segment, whose primary products are private passenger automobile and homeowners insurance, accounted for 56% of the Company's insurance premiums written and contract deposits for the year ended December 31, 2005; the annuity and life insurance segments together accounted for 44% of insurance premiums written and contract deposits for the year ended December 31, 2005 (33% and 11%, respectively).

The Company is one of the largest participants in the 403(b) tax-qualified annuity market, measured by 403(b) net written premium on a statutory accounting basis. The Company's 403(b) tax-qualified annuities are annuities purchased voluntarily by individuals employed by public school systems or other tax-exempt organizations. The Company has approved 403(b) payroll reduction capabilities in approximately one-third of the 14,000 public school districts in the U.S.

The Company's investment portfolio had an aggregate fair value of \$4.0 billion at December 31, 2005. Investments consist principally of investment grade, publicly traded fixed income securities.

The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and all amendments to those reports are available free of charge through the Investor Relations section of the Company's Internet website, [www.horacemann.com](http://www.horacemann.com), as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission ("SEC"). The EDGAR filings of such reports are also available at the SEC's website, [www.sec.gov](http://www.sec.gov).

Also available in the Investor Relations section of the Company's Internet website are its corporate governance principles, code of conduct and code of ethics as well as the charters of the Board's Audit Committee, Compensation Committee, Executive Committee, Investment and Finance Committee, and Nominating and Governance Committee.

Louis G. Lower II, CEO of HMEC, timely submitted the Annual Section 12(a) CEO Certification to the New York Stock Exchange ("NYSE") on June 17, 2005 without any qualifications. The Company filed with the SEC, as exhibits to the Annual Report on Form 10-K for the year ended December 31, 2004, the CEO and CFO certifications required under Section 302 of the Sarbanes-Oxley Act.

## **History**

The Company's business was founded in Springfield, Illinois in 1945 by two school teachers to sell automobile insurance to other teachers within the State of Illinois. The Company expanded its business to other states and broadened its product line to include life insurance in 1949, 403(b) tax-qualified retirement annuities in 1961 and homeowners insurance in 1965. In November 1991, HMEC completed an initial public offering of its common stock (the "IPO"). The common stock is traded on the New York Stock Exchange under the symbol "HMN".

## SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA

The following consolidated statement of operations and balance sheet data have been derived from the consolidated financial statements of the Company. The consolidated financial statements of the Company for each of the years in the five-year period ended December 31, 2005 have been audited by KPMG LLP, an independent registered public accounting firm. The following selected historical consolidated financial data should be read in conjunction with the consolidated financial statements of HMEC and its subsidiaries and Management's Discussion and Analysis of Financial Condition and Results of Operations.

|  | Year Ended December 31,                      |           |           |           |           |
|--|--|-----------|-----------|-----------|-----------|
|  | 2005   | 2004      | 2003      | 2002      | 2001      |
| <b>Statement of Operations Data:</b>                   |  |           |           |           |           |
|  | (Dollars in millions, except per share data) |           |           |           |           |
| Insurance premiums written and contract deposits ..... | \$ 972.6                                     | \$ 998.4  | \$ 955.5  | \$ 899.3  | \$ 875.6  |
| Insurance premiums and contract charges earned .....   | 664.9  | 674.7     | 643.5     | 625.2     | 615.2     |
| Net investment income .....                            | 194.6  | 191.4     | 184.7     | 196.0     | 199.3     |
| Realized investment gains (losses) .....               | 9.8  | 12.2      | 25.5      | (49.4)    | (10.0)    |
| Total revenues .....                                   | 869.3  | 878.3     | 853.7     | 771.8     | 804.5     |
| Amortization of intangible assets (1) .....            | 5.1  | 6.0       | 5.0       | 5.7       | 5.8       |
| Interest expense .....                                 | 8.9  | 6.8       | 6.3       | 8.5       | 9.3       |
| Income before income taxes .....                       | 94.0   | 69.7      | 19.2      | 7.7       | 28.3      |
| Net income (2) .....                                   | 77.3   | 56.3      | 19.0      | 11.3      | 25.6      |
| Ratio of earnings to fixed charges (3) .....           | 1.8x   | 1.6x      | 1.2x      | 1.1x      | 1.3x      |
| <b>Per Share Data (4):</b>                             |  |           |           |           |           |
| Net income:  |  |           |           |           |           |
| Basic .....  | \$ 1.80                                      | \$ 1.32   | \$ 0.44   | \$ 0.28   | \$ 0.63   |
| Diluted .....  | \$ 1.67                                      | \$ 1.25   | \$ 0.44   | \$ 0.28   | \$ 0.63   |
| Shares of Common Stock - weighted average:             |  |           |           |           |           |
| Basic .....  | 42.9   | 42.8      | 42.7      | 40.9      | 40.6      |
| Diluted .....  | 47.9   | 47.3      | 42.9      | 41.2      | 40.9      |
| Shares of Common Stock - ending outstanding .....      | 43.0   | 42.8      | 42.7      | 42.7      | 40.7      |
| Cash dividends .....                                   | \$ 0.42                                      | \$ 0.42   | \$ 0.42   | \$ 0.42   | \$ 0.42   |
| Book value per share .....                             | \$ 13.51                                     | \$ 13.45  | \$ 12.42  | \$ 12.39  | \$ 11.27  |
| <b>Balance Sheet Data, at Year End:</b>                |  |           |           |           |           |
| Total investments .....                                | \$3,996.5                                    | \$3,657.2 | \$3,385.7 | \$3,130.6 | \$2,975.7 |
| Total assets .....                                     | 5,840.6                                      | 5,371.9   | 4,953.2   | 4,453.6   | 4,455.1   |
| Total policy liabilities .....                         | 3,172.1                                      | 3,010.6   | 2,787.0   | 2,585.2   | 2,445.2   |
| Short-term debt .....                                  | -  | 25.0      | 25.0      | -         | 53.0      |
| Long-term debt .....                                   | 190.9  | 144.7     | 144.7     | 144.7     | 99.8      |
| Total shareholders' equity .....                       | 580.6  | 576.2     | 530.5     | 528.8     | 459.2     |
| <b>Segment Information (5):</b>                        |  |           |           |           |           |
| Insurance premiums written and contract deposits       |  |           |           |           |           |
| Property and casualty .....                            | \$ 546.9                                     | \$ 562.3  | \$ 546.5  | \$ 524.9  | \$ 519.3  |
| Annuity .....  | 320.1  | 327.0     | 296.6     | 261.5     | 239.1     |
| Life .....   | 105.6  | 109.1     | 112.4     | 112.9     | 117.2     |
| Total .....  | 972.6  | 998.4     | 955.5     | 899.3     | 875.6     |
| Net income (loss)                                      |  |           |           |           |           |
| Property and casualty .....                            | \$ 45.0                                      | \$ 27.6   | \$ (17.8) | \$ 19.9   | \$ 5.2    |
| Annuity .....  | 15.1   | 12.6      | 14.4      | 17.0      | 20.6      |
| Life .....   | 13.4   | 14.8      | 13.4      | 18.9      | 18.7      |
| Corporate and other (2) (6) .....                      | 3.8  | 1.3       | 9.0       | (44.5)    | (18.9)    |
| Total .....  | 77.3   | 56.3      | 19.0      | 11.3      | 25.6      |

- (1) Amortization of intangible assets is comprised of amortization of goodwill and amortization of acquired value of insurance in force and is the result of purchase accounting adjustments related to the 1989 acquisition of the Company and the 1994 acquisition of HMPCIC. Effective January 1, 2002, the Company adopted Financial Accounting Standard ("FAS") No. 142, "Goodwill and Other Intangible Assets". Under FAS No. 142, goodwill amortization ceases and the goodwill is annually tested for impairment. Goodwill amortization was \$1.6 million for the year ended December 31, 2001.
- (2) In 2005, the Company's federal income tax expense reflected a reduction of \$9.1 million from the closing of tax years 1996 through 2001 with favorable resolution of the contingent tax liabilities related to those prior tax years. In 1999, the Company recorded a charge of \$20.0 million for an additional federal income tax provision representing the Company's maximum exposure for disputed prior years' taxes (for tax years 1994 through 1997). Resolution of the portion of this dispute related to the 1997 tax year resulted in a \$1.3 million benefit in 2001.
- (3) For the purpose of determining the ratio of earnings to fixed charges, "earnings" consist of income before income taxes and fixed charges, and "fixed charges" consist of interest expense (including amortization of debt issuance cost) and interest credited to policyholders on interest-sensitive contracts.
- (4) Basic earnings per share is computed based on the weighted average number of shares outstanding. Diluted earnings per share is computed based on the weighted average number of shares and common stock equivalents outstanding. The Company's common stock equivalents relate to outstanding common stock options, Director Stock Plan units, Employee Stock Plan units and restricted stock units. The Company's Senior Convertible Notes, which were issued in May 2002, are considered potentially dilutive securities and are included in the calculation of diluted earnings per share, to the extent dilutive, per Emerging Issues Task Force ("EITF") issue 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share".
- (5) Information regarding assets by segment at December 31, 2005, 2004 and 2003 is contained in "Notes to Consolidated Financial Statements -- Note 13 -- Segment Information" listed on page F-1 of this report.
- (6) The corporate and other segment primarily includes interest expense on debt and the impact of realized investment gains and losses, restructuring charges, debt retirement costs, litigation charges, provision for/resolution of prior years' taxes and certain public company expenses.

## Corporate Strategy and Marketing

### *The Horace Mann Value Proposition*

The Horace Mann Value Proposition articulates the Company's overarching strategy and business purpose: Provide lifelong financial well-being for educators and their families through personalized service, advice, and a full range of tailored insurance and financial products.

### *Target Market*

Management believes that Horace Mann is the largest national multiline insurance company focused on the nation's educators as its primary market. The Company's target market consists of educators and other employees of public schools and their families located throughout the U.S. The U.S. Department of Education estimates that there are approximately 3.5 million elementary and secondary teachers in public and private schools in the U.S. The Company also markets its products to other education-related customers, including school administrators, education support personnel, private school teachers, community college personnel and customer referrals.

### *Exclusive Agency Force*

A cornerstone of the Company's marketing strategy is its exclusive sales force of full-time employee agents trained to sell multiline products. As of December 31, 2005, the Company employed 855 full-time agents, approximately 80% of which are licensed by the National Association of Securities Dealers, Inc. ("NASD") to sell variable annuities. Many of the Company's agents were previously teachers, other members of the education profession or persons with close ties to the educational community. The Company's agents are under contract to market only the Company's products and limited additional third-party vendor products authorized by the Company. Collectively, the Company's principal insurance subsidiaries are licensed to write business in 49 states and the District of Columbia.

### *Broadening Distribution Options*

Management has begun to broaden the Company's distribution options to complement and extend the reach of the Company's agency force. This initiative initially focuses on more fully utilizing its approved payroll deduction slots in school systems across the country which are assigned to Horace Mann. In 2001, the Company began building a network of independent agents who comprise a second distribution channel for the Company's 403(b) tax-qualified annuity products. In addition to serving educators in areas where the Company does not have agents, the independent agents will complement and extend the annuity capabilities of the Company's agents in under-penetrated areas.

As an example of the potential for this initiative, in January 2002 the Company announced that it had been selected as one of four providers of fixed and variable annuity options to Chicago, Illinois public school employees. At the time of this Report on Form 10-K, there are six annuity providers serving the Chicago Public Schools. The Chicago Public Schools is the third-largest school district in the U.S. Beginning in April 2002, the Company is partnering with a firm, which has been providing retirement planning services to Chicago Public School employees for more than two decades, to pursue this opportunity to bolster growth in its annuity business. At December 31, 2005, there were 759 independent agents approved to market the Company's annuity products throughout the U.S. During 2005, collected contract deposits from this distribution channel were approximately \$41 million.

## Geographic Composition of Business

The Company's business is geographically diversified. For the year ended December 31, 2005, based on direct insurance premiums and contract deposits for all product lines, the top five states and their portion of total premiums were North Carolina, 7.1%; Illinois, 6.6%; Florida, 6.3%; Minnesota, 5.5%; and California, 5.5%.

HMEC's property and casualty subsidiaries write business in 48 states and the District of Columbia. The following table sets forth the Company's top ten property and casualty states based on total direct premiums in 2005:

### Property and Casualty Segment Top Ten States (Dollars in millions)

| State                         | Property and Casualty Segment |                  |
|-------------------------------|-------------------------------|------------------|
|                               | Direct Premiums (1)           | Percent of Total |
| Florida .....                 | \$ 47.5                       | 8.4%             |
| California .....              | 46.7                          | 8.3              |
| North Carolina .....          | 42.0                          | 7.4              |
| Minnesota .....               | 40.4                          | 7.1              |
| Louisiana .....               | 25.6                          | 4.5              |
| Pennsylvania .....            | 25.4                          | 4.5              |
| Texas .....                   | 24.8                          | 4.4              |
| South Carolina .....          | 23.8                          | 4.2              |
| Michigan .....                | 19.5                          | 3.5              |
| Maine .....                   | 18.8                          | 3.3              |
| Total of top ten states ..... | 314.5                         | 55.6             |
| All other areas .....         | 251.1                         | 44.4             |
| Total direct premiums .....   | <u>\$565.6</u>                | <u>100.0%</u>    |

(1) Defined as earned premiums before reinsurance and is determined under statutory accounting principles.

HMEC's principal life insurance subsidiary writes business in 48 states and the District of Columbia. The following table sets forth the Company's top ten combined life and annuity states based on total direct premiums and contract deposits in 2005:

### Combined Life and Annuity Segments Top Ten States (Dollars in millions)

| State                         | Direct Premiums and Contract Deposits (1) | Percent of Total |
|-------------------------------|---|------------------|
| Illinois .....                | \$ 52.3                                   | 12.1%            |
| North Carolina .....          | 29.1                                      | 6.7              |
| Virginia .....                | 27.2                                      | 6.3              |
| South Carolina .....          | 23.9                                      | 5.5              |
| Texas .....                   | 18.0                                      | 4.2              |
| Tennessee .....               | 16.9                                      | 3.9              |
| Pennsylvania .....            | 16.6                                      | 3.8              |
| Indiana .....                 | 16.3                                      | 3.8              |
| Florida .....                 | 15.9                                      | 3.7              |
| Minnesota .....               | 14.8                                      | 3.4              |
| Total of top ten states ..... | 231.0                                     | 53.4             |
| All other areas .....         | 201.8                                     | 46.6             |
| Total direct premiums .....   | <u>\$432.8</u>                            | <u>100.0%</u>    |

(1) Defined as collected premiums before reinsurance and is determined under statutory accounting principles.

## *National, State and Local Education Associations*

The Company has had a long relationship with the National Education Association (“NEA”), the nation’s largest confederation of state and local teachers’ associations, and many of the state and local education associations affiliated with the NEA. The NEA has approximately 2.7 million members. The Company maintains a special advisory board, primarily composed of leaders of state education associations, that meets with Company management on a regular basis. The NEA and its affiliated state and local associations sponsor various insurance products and services of the Company and its competitors.

From 1984 to September 1993 and beginning again in September 1996, the NEA purchased from the Company educator excess professional liability insurance for all of its members. The NEA has entered into a contract to purchase this insurance from the Company through August 2007. Premiums from this product represent less than 1% of all insurance premiums written and contract deposits of the Company.

### **Property and Casualty Segment**

The property and casualty segment represented 56% of the Company’s total insurance premiums written and contract deposits.

The primary property and casualty product offered by the Company is private passenger automobile insurance, which in 2005 represented 39% of the Company’s total insurance premiums written and contract deposits and 70% of property and casualty net written premiums. As of December 31, 2005, the Company had approximately 531,000 voluntary automobile policies in force with annual premiums of approximately \$391 million. The Company’s automobile business is primarily preferred risk, defined as a household whose drivers have had no recent accidents and no more than one recent moving violation.

In 2005, homeowners insurance represented 16% of the Company’s total insurance premiums written and contract deposits and 28% of property and casualty net written premiums. The Company insures primarily residential homes. As of December 31, 2005, the Company had approximately 266,000 homeowners policies in force with annual premiums of approximately \$176 million. As expected, the number of homeowners policies in force decreased in 2005, reflecting initiatives to improve profitability in this product line.

Educator excess professional liability insurance represented less than 1% of the Company’s 2005 property and casualty premiums. See “Corporate Strategy and Marketing -- National, State and Local Education Associations”.

The Company has programs in a majority of states to provide higher-risk automobile and homeowners coverages, with third-party vendors underwriting and bearing the risk of such insurance and the Company receiving commissions on the sales.

## Selected Historical Financial Information For Property and Casualty Segment

The following table sets forth certain financial information with respect to the property and casualty segment for the periods indicated.

### Property and Casualty Segment Selected Historical Financial Information (Dollars in millions)

|   | Year Ended December 31, |         |         |
|---|-------------------------|---------|---------|
|   | 2005                    | 2004    | 2003    |
| <b>Statement of Operations Data:</b>  |                         |         |         |
| Insurance premiums written (1) (2).....                                     | \$546.9                 | \$562.3 | \$546.5 |
| Insurance premiums earned (1) .....   | 549.6                   | 561.3   | 533.8   |
| Net investment income.....  | 33.2                    | 33.8    | 31.9    |
| Income (loss) before income taxes.....                                      | 58.0                    | 29.5    | (35.2)  |
| Net income (loss) .....   | 45.0                    | 27.6    | (17.8)  |
| Catastrophe costs, pretax (3).....  | 69.2                    | 75.5    | 33.2    |
| <b>Operating Statistics:</b>  |                         |         |         |
| Loss and loss adjustment expense ratio.....                                 | 72.4%                   | 78.3%   | 88.6%   |
| Expense ratio .....   | 23.2%                   | 22.2%   | 23.7%   |
| Combined loss and expense ratio<br>(including policyholder dividends) ..... | 95.6%                   | 100.5%  | 112.3%  |
| Effect of catastrophe costs on the combined ratio (3) .....                 | 12.3%                   | 13.4%   | 6.2%    |
| <b>Automobile and Homeowners (Voluntary):</b>                               |                         |         |         |
| Insurance premiums written (1) (2).....                                     | \$535.2                 | \$552.5 | \$549.2 |
| Insurance premiums earned (1) .....   | 538.8                   | 552.0   | 534.8   |
| Policies in force (in thousands) .....                                      | 797                     | 818     | 850     |

(1) As a result of catastrophes in the third quarter of both 2005 and 2004, the Company incurred additional ceded written and earned premiums to reinstate its property and casualty catastrophe reinsurance coverage of \$9.9 million and \$5.0 million for the years ended December 31, 2005 and 2004, respectively.

(2) Reflecting resolution of the challenge to automobile rates in North Carolina, in 2004 the Company returned to policyholders \$4.0 million of previously escrowed premiums, resulting in a reduction to written premiums.

(3) These measures are used by the Company's management to evaluate performance against historical results and establish targets on a consolidated basis. These measures are components of net income but are considered non-GAAP financial measures under applicable SEC rules because they are not displayed as separate line items in the Consolidated Statement of Operations and require inclusion or exclusion of certain items not ordinarily included or excluded in a GAAP financial measure. In the opinion of the Company's management, a discussion of these measures is meaningful to provide investors with an understanding of the significant factors that comprise the Company's periodic results of operations.

- Catastrophe costs - The sum of catastrophe losses and property and casualty catastrophe reinsurance reinstatement premiums.
- Catastrophe losses - In categorizing property and casualty claims as being from a catastrophe, the Company utilizes the designations of the Insurance Services Office, Inc. ("ISO") and reports loss and loss adjustment expense amounts net of reinsurance recoverables. A catastrophe is a severe loss resulting from natural and man-made events within a particular territory, including risks such as hurricane, fire, earthquake, windstorm, explosion, terrorism and other similar events, that causes \$25 million or more in insured property and casualty losses for the industry and affects a significant number of property and casualty insurers and policyholders. Each catastrophe has unique characteristics. Catastrophes are not predictable as to timing or amount in advance, and therefore their effects are not included in earnings or claim and claim adjustment expense reserves prior to occurrence. In the opinion of the Company's management, a discussion of the impact of catastrophes is meaningful for investors to understand the variability in periodic earnings.

## Catastrophe Costs

The level of catastrophe costs can fluctuate significantly from year to year. Catastrophe costs before federal income tax benefits for the Company and the property and casualty industry for the ten years ended December 31, 2005 were as follows:

| Year Ended December 31, | Catastrophe Costs<br>(Dollars in millions) |  |
|-------------------------|--|--|
|                         | The<br>Company (1)                         | Property and<br>Casualty<br>Industry (2) |
| 2005 .....              | \$69.2                                     | \$56,800.0                               |
| 2004 .....              | 75.5                                       | 27,300.0                                 |
| 2003 .....              | 33.2                                       | 12,900.0                                 |
| 2002 .....              | 11.9                                       | 5,900.0                                  |
| 2001 .....              | 11.2                                       | 26,500.0                                 |
| 2000 .....              | 16.2                                       | 4,600.0                                  |
| 1999 .....              | 19.6                                       | 8,300.0                                  |
| 1998 .....              | 28.4                                       | 10,100.0                                 |
| 1997 .....              | 6.2  | 2,600.0                                  |
| 1996 .....              | 20.9                                       | 7,400.0                                  |

(1) Net of reinsurance and before federal income tax benefits. Includes allocated loss adjustment expenses and reinsurance reinstatement premiums. The Company's individually significant catastrophe losses net of reinsurance were as follows:

2005 - \$23.7 million, Hurricane Katrina; \$15.0 million, Hurricane Wilma; \$10.8 million, Hurricane Rita; \$6.5 million, September Minnesota tornadoes; \$5.0 million, Hurricane Dennis.

2004 - \$19.9 million, Hurricane Charley; \$11.9 million, Hurricane Frances; \$19.2 million, Hurricane Ivan; \$18.2 million, Hurricane Jeanne.

2003 - \$12.0 million, California wildfires; \$9.6 million, May hail/tornadoes/wind; \$5.0 million, Hurricane Isabel; \$2.7 million, early April winter storms.

2002 - \$4.2 million, Hurricane Lili; \$1.7 million, April Eastern states hail, tornadoes, wind and heavy rain; \$1.2 million, Eastern states winter storms.

2001 - \$3.7 million, June Midwest wind/hail/tornadoes; \$2.3 million, April tornadoes; \$2.2 million, Tropical Storm Allison.

2000 - \$5.0 million, May tornadoes; \$2.7 million, December winter storms.

1999 - \$5.4 million, Hurricane Floyd; \$3.1 million, May tornadoes primarily in Oklahoma.

1998 - \$7.9 million, May Minnesota hailstorm; \$2.9 million, May Upper Midwest hailstorm; \$2.0 million, June Midwest wind/hail; \$1.6 million, Hurricane Georges.

1997 - \$1.4 million, July wind/hail/tornadoes; \$1.1 million, Denver, Colorado hailstorm.

1996 - \$8.2 million, Hurricane Fran.

(2) Source: Insurance Services Office, Inc. news release dated January 26, 2006. These amounts represent anticipated insured losses from catastrophes for personal and commercial property items, business interruption and additional living expenses and are net of reinsurance, before federal income tax benefits, and exclude all loss adjustment expenses.

Fluctuations from year to year in the level of catastrophe losses impact a property and casualty insurance company's loss and loss adjustment expenses incurred and paid. For comparison purposes, the following table provides amounts for the Company excluding catastrophe losses:

|   | Impact of Catastrophe Losses (1)<br>(Dollars in millions) |                |                |
|---|---|----------------|----------------|
|   | Year Ended December 31,                                   |                |                |
|   | 2005  | 2004           | 2003           |
| Claims and claim expense incurred (2) ..... | \$398.0   | \$439.3        | \$472.9        |
| Amount attributable to catastrophes .....   | <u>59.3</u>   | <u>70.5</u>    | <u>33.2</u>    |
| Excluding catastrophes (2) .....            | <u>\$338.7</u>  | <u>\$368.8</u> | <u>\$439.7</u> |
| Claims and claim expense payments .....     | \$396.2   | \$413.7        | \$420.2        |
| Amount attributable to catastrophes .....   | <u>50.9</u>   | <u>42.8</u>    | <u>21.4</u>    |
| Excluding catastrophes .....                | <u>\$345.3</u>  | <u>\$370.9</u> | <u>\$398.8</u> |

(1) Net of reinsurance and before federal income tax benefits. Includes allocated loss adjustment expenses.

(2) Includes the impact of development of prior years' reserves as quantified in "Property and Casualty Reserves".

## *Property and Casualty Reserves*

Property and casualty unpaid claims and claim settlement expenses ("loss reserves") represent management's estimate of ultimate unpaid costs of losses and settlement expenses for claims that have been reported and claims that have been incurred but not yet reported. The process for estimating these liabilities begins with the collection and analysis of claim data. Data on individual reported claims, both current and historical, including paid amounts and individual claim adjuster estimates, are grouped by common characteristics and evaluated by actuaries in their analyses of ultimate claim liabilities by product line. Such data is supplemented with external data as available and when appropriate. The process of analyzing loss reserves for all product lines is undertaken on a quarterly basis.

Multiple estimation methods are available for the analysis of ultimate claim liabilities. Some of the techniques used include development of paid loss dollars, development of reported loss dollars, methods based on the expected loss ratio and methods utilizing frequency and severity of losses. These methods tend to converge over time, with the broadest range of results observed initially. The short-tailed coverages, such as property coverages, tend to converge more quickly than the long-tailed liability lines. Each estimation method has its own set of assumption variables and its own advantages and disadvantages, with no single estimation method being better than the others in all situations and no one set of assumption variables being meaningful for all product lines. The relative strengths and weaknesses of the particular estimation methods when applied to a particular group of claims can also change over time. Therefore, the actual choice of estimation method(s) can change with each evaluation. The estimation method(s) chosen are those that are believed to produce the most reliable indication at that particular evaluation date for the claim liabilities being evaluated.

In most cases, multiple estimation methods will be valid for the particular facts and circumstances of the claim liabilities being evaluated. This will result in a range of reasonable estimates for any particular claim liability. The Company uses such range analyses to back test whether previously established estimates for reserves are reasonable, given subsequent information. Reported values found to be closer to the endpoints of a range of reasonable estimates are subject to further detailed reviews. These reviews may substantiate the validity of management's recorded estimate or lead to a change in the reported estimate.

The exact boundary points of these ranges are more qualitative than quantitative in nature, as no clear line of demarcation exists to determine when the set of underlying assumptions for an estimation method switches from being reasonable to unreasonable. As a result, the Company does not believe that the endpoints of these ranges are or would be comparable across companies. In addition, potential interactions among the different estimation assumptions for different product lines make the aggregation of individual ranges a highly judgmental and inexact process.

A key assumption in most actuarial analyses is that past patterns demonstrated in the data will repeat themselves in the future, absent a significant change in the associated risk factors discussed below. To the extent a significant change affecting the ultimate claim liability is known, such change is quantified to the extent possible through an analysis of internal Company and, if available and when appropriate, external data. Such a measurement is specific to the facts and circumstances of the particular claim portfolio and the known change being evaluated.

Informed management judgment is applied throughout the reserving process. This includes the application, on a consistent basis over time, of various individual experiences and expertise to multiple sets of data and analyses. In addition to actuaries, individuals involved with the reserving process also include underwriting and claims personnel as well as other Company management. Therefore, it is quite possible and generally likely that management must consider varying individual viewpoints as part of its estimation of loss reserves.

The variables discussed above in this general discussion have different impacts on reserve estimation uncertainty for a given product line, depending on the length of the claim tail (described below), the reporting lag, the impact of individual claims and the complexity of the claim process for a given product line.

Product lines are generally classified as either long-tail or short-tail, based on the average length of time between the event triggering claims under a policy and the final resolution of those claims. Short-tail claims are reported and settled quickly, resulting in less estimation variability. The longer the time before final claim resolution, the greater the exposure to estimation risks and hence the greater the estimation uncertainty.

A major component of the claim tail is the reporting lag. The reporting lag, which is the time between the event triggering a claim and the reporting of the claim to the insurer, makes estimating incurred but not reported ("IBNR") reserves inherently more uncertain. In addition, the greater the reporting lag, the greater the proportion of IBNR claims to the total claim liability for the product line.

For some lines, the impact of large individual claims can be material to the analysis. These lines are generally referred to as being low frequency/high severity, while lines without this large claim sensitivity are referred to as high frequency/low severity. Estimates of claim liabilities for low frequency/high severity lines can be sensitive to a few key assumptions. As a result, the role of judgment is much greater for these reserve estimates. In contrast, high frequency/low severity lines tend to have a lower level of volatility, such that the range of reasonable reserve estimates is narrower and more stable.

Claim complexity can also greatly affect the estimation process by impacting the number of assumptions needed to produce the estimate, the potential stability of the underlying data and claim process and the ability to gain an understanding of the data. Product lines with greater claim complexity have inherently greater estimation uncertainty.

Actuaries have to exercise a considerable degree of judgment in the evaluation of all these factors in their analysis of reserves. The human element in the application of actuarial judgment is unavoidable when faced with material uncertainty. Different actuaries will choose different assumptions when faced with such uncertainty, based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimate selected by the various actuaries may differ materially from each other.

The major causes of significant uncertainty ("risk factors") generally will vary for each product line, as well as for each separately analyzed coverage of the product line. In some cases, such risk factors are explicit assumptions of the estimation method, and in others, they are implicit. For example, a method may explicitly assume a certain claim reporting pattern, but implicitly assume that the Company's claim handling process is consistent over time. Actual results will likely vary from expectations for each of these assumptions, resulting in an ultimate claim liability that is different from that being estimated currently.

At December 31, 2005, all of the Company's reserves for unpaid claims and claim expenses were carried at the full value of estimated liabilities and were not discounted for interest expected to be earned on reserves. Due to the nature of the Company's personal lines business, the Company has no exposure to claims for toxic waste cleanup, other environmental remediation or asbestos-related illnesses other than claims under homeowners insurance policies for environmentally related items such as mold.

The following table is a summary reconciliation of the beginning and ending property and casualty insurance claims and claim expense reserves, displayed individually for each of the last three years. The table presents reserves on a net (after reinsurance) basis. The total net property and casualty insurance claims and claim expense incurred amounts are reflected in the Consolidated Statements of Operations listed on page F-1 of this report. The end of the year gross reserve (before reinsurance) balances are reflected in the Consolidated Balance Sheets also listed on page F-1 of this report.

**Reconciliation of Property and Casualty Claims and Claim Expense Reserves**  
(Dollars in millions)

|   | <u>Year Ended December 31,</u> |                |                |
|---|--------------------------------|----------------|----------------|
|   | <u>2005</u>                    | <u>2004</u>    | <u>2003</u>    |
| Gross reserves, beginning of year .....   | \$335.0                        | \$304.3        | \$275.7        |
| Less reinsurance recoverables .....   | <u>25.7</u>                    | <u>20.6</u>    | <u>44.7</u>    |
| Net reserves, beginning of year (1) .....   | <u>309.3</u>                   | <u>283.7</u>   | <u>231.0</u>   |
| Incurred claims and claim expenses:   |                                |                |                |
| Claims occurring in the current year.....   | 411.1                          | 435.5          | 416.5          |
| Increase (decrease) in estimated reserves for claims<br>occurring in prior years (2): |                                |                |                |
| Policies written by the Company .....   | (13.1)                         | 3.8            | 58.3           |
| Business assumed from state reinsurance facilities.....                               | <u>-</u>                       | <u>-</u>       | <u>(1.9)</u>   |
| Total increase (decrease).....  | <u>(13.1)</u>                  | <u>3.8</u>     | <u>56.4</u>    |
| Total claims and claim expenses incurred (3).....                                     | <u>398.0</u>                   | <u>439.3</u>   | <u>472.9</u>   |
| Claims and claim expense payments for claims occurring during:                        |                                |                |                |
| Current year .....  | 252.3                          | 268.5          | 259.8          |
| Prior years.....  | <u>143.9</u>                   | <u>145.2</u>   | <u>160.4</u>   |
| Total claims and claim expense payments .....   | <u>396.2</u>                   | <u>413.7</u>   | <u>420.2</u>   |
| Net reserves, end of year (1).....  | 311.1                          | 309.3          | 283.7          |
| Plus reinsurance recoverables.....  | <u>31.6</u>                    | <u>25.7</u>    | <u>20.6</u>    |
| Reported gross reserves, end of year (4).....   | <u>\$342.7</u>                 | <u>\$335.0</u> | <u>\$304.3</u> |

(1) Reserves net of anticipated reinsurance recoverables.

(2) Shows the amounts by which the Company increased or decreased its reserves in each of the periods indicated for claims occurring in previous periods to reflect subsequent information on such claims and changes in their projected final settlement costs. For discussion of the reserve development recorded by the Company in 2005, 2004 and 2003, see "Notes to Consolidated Financial Statements -- Note 3 -- Property and Casualty Unpaid Claims and Claim Expenses" listed on page F-1 of this report.

(3) Benefits, claims and settlement expenses as reported in the Consolidated Statements of Operations, listed on page F-1 of this report, also include life, annuity, group accident and health and corporate amounts of \$44.7 million, \$45.1 million and \$46.1 million for the years ended December 31, 2005, 2004 and 2003, respectively, in addition to the property and casualty amounts.

(4) Unpaid claims and claim expenses as reported in the Consolidated Balance Sheets, listed on page F-1 of this report, also include life, annuity, and group accident and health reserves of \$8.1 million, \$7.4 million and \$9.0 million at December 31, 2005, 2004 and 2003, respectively, in addition to property and casualty reserves.

The claim reserve development table below illustrates the change over time in the Net Reserves (defined in footnote 1 to the table above) established for property and casualty insurance claims and claim expenses at the end of various calendar years. The first section shows the reserves as originally reported at the end of the stated year. The second section, reading down, shows the cumulative amounts of claims for which settlements have been made in cash as of the end of successive years with respect to that reserve liability. The third section, reading down, shows retroactive reestimates of the original recorded reserve as of the end of each successive year which is the result of the Company's learning additional facts that pertain to the unsettled claims. The fourth section compares the latest reestimated reserve to the reserve originally established, and indicates whether or not the original reserve was adequate or inadequate to cover the estimated costs of unsettled claims. The table also presents the gross reestimated liability as of the end of the latest reestimation period, with separate disclosure of the related reestimated reinsurance recoverable. The claim reserve development table is cumulative and, therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both the current and prior years.

In evaluating the information in the table below, it should be noted that each amount includes the effects of all changes in amounts of prior periods. For example, if a claim determined in 2004 to be \$150 thousand was first reserved in 1995 at \$100 thousand, the \$50 thousand deficiency (actual claim minus original estimate) would be included in the cumulative deficiency in each of the years 1995 - 2003 shown below. This table presents development data by calendar year and does not relate the data to the year in which the accident actually occurred. Conditions and trends that have affected the development of these reserves in the past will not necessarily recur in the future. It may not be appropriate to use this cumulative history in the projection of future performance.

**Property and Casualty  
Claims and Claims Expense Reserve Development**  
(Dollars in millions)

December 31,

|   | 1995    | 1996    | 1997    | 1998      | 1999      | 2000      | 2001      | 2002      | 2003     | 2004    | 2005    |
|---|---------|---------|---------|-----------|-----------|-----------|-----------|-----------|----------|---------|---------|
| Gross reserves for property and casualty claims and claim expenses.....                                   | \$349.1 | \$318.7 | \$289.1 | \$275.6   | \$271.2   | \$272.1   | \$275.7   | \$275.7   | \$304.3  | \$335.0 | \$342.7 |
| Deduct: Reinsurance recoverables.....   | 23.8    | 34.1    | 41.3    | 55.9      | 64.4      | 49.1      | 34.1      | 44.7      | 20.6     | 25.7    | 31.6    |
| Net Reserves for property and casualty claims and claim expenses (1).....                                 | 325.3   | 284.6   | 247.8   | 219.7     | 206.8     | 223.0     | 241.6     | 231.0     | 283.7    | 309.3   | 311.1   |
| Paid cumulative as of:  |         |         |         |           |           |           |           |           |          |         |         |
| One year later.....   | 125.1   | 133.4   | 127.0   | 129.3     | 135.9     | 139.0     | 153.4     | 160.4     | 145.2    | 143.9   |         |
| Two years later.....  | 178.7   | 184.3   | 174.9   | 185.7     | 191.6     | 202.6     | 226.0     | 222.3     | 209.5    |         |         |
| Three years later.....  | 205.1   | 206.5   | 205.0   | 215.4     | 225.4     | 243.3     | 258.4     | 258.6     |          |         |         |
| Four years later.....   | 215.1   | 220.8   | 219.5   | 232.1     | 246.9     | 256.1     | 276.3     |           |          |         |         |
| Five years later.....   | 222.1   | 226.6   | 227.7   | 243.3     | 252.7     | 264.1     |           |           |          |         |         |
| Six years later.....  | 224.7   | 230.9   | 234.2   | 245.1     | 257.6     |           |           |           |          |         |         |
| Seven years later.....  | 227.5   | 234.9   | 235.0   | 249.0     |           |           |           |           |          |         |         |
| Eight years later.....  | 230.0   | 235.0   | 237.3   |           |           |           |           |           |          |         |         |
| Nine years later.....   | 229.9   | 237.2   |         |           |           |           |           |           |          |         |         |
| Ten years later.....  | 231.5   |         |         |           |           |           |           |           |          |         |         |
| Net Reserves reestimated as of (1):   |         |         |         |           |           |           |           |           |          |         |         |
| End of year.....  | 325.3   | 284.6   | 247.8   | 219.7     | 206.8     | 223.0     | 241.6     | 231.0     | 283.7    | 309.3   | 311.1   |
| One year later.....   | 262.8   | 239.5   | 222.9   | 215.1     | 229.5     | 239.5     | 265.6     | 287.3     | 287.5    | 296.2   |         |
| Two years later.....  | 229.0   | 228.5   | 217.8   | 237.9     | 248.3     | 260.5     | 294.7     | 297.1     | 283.1    |         |         |
| Three years later.....  | 225.2   | 226.1   | 233.4   | 245.4     | 256.0     | 277.0     | 301.3     | 297.9     |          |         |         |
| Four years later.....   | 223.2   | 235.4   | 235.5   | 248.0     | 266.9     | 280.2     | 298.5     |           |          |         |         |
| Five years later.....   | 230.3   | 234.7   | 237.2   | 254.7     | 269.3     | 277.9     |           |           |          |         |         |
| Six years later.....  | 229.5   | 237.1   | 241.2   | 257.8     | 268.1     |           |           |           |          |         |         |
| Seven years later.....  | 231.6   | 239.5   | 245.1   | 257.1     |           |           |           |           |          |         |         |
| Eight years later.....  | 233.7   | 244.2   | 245.0   |           |           |           |           |           |          |         |         |
| Nine years later.....   | 238.1   | 244.4   |         |           |           |           |           |           |          |         |         |
| Ten years later.....  | 238.6   |         |         |           |           |           |           |           |          |         |         |
| Net Reserve redundancy (deficiency) – initial net reserves in excess of (less than) reestimated reserves: |         |         |         |           |           |           |           |           |          |         |         |
| Amount (2).....   | \$ 86.7 | \$ 40.2 | \$ 2.8  | \$ (37.4) | \$ (61.3) | \$ (54.9) | \$ (56.9) | \$ (66.9) | \$ 0.6   | \$ 13.1 |         |
| Percent.....  | 26.7%   | 14.1%   | 1.1%    | -17.0%    | -29.6%    | -24.6%    | -23.6%    | -29.0%    | 0.2%     | 4.2%    |         |
| Gross reestimated liability - latest.....   | \$267.5 | \$278.3 | \$278.1 | \$300.2   | \$311.1   | \$321.8   | \$345.4   | \$347.4   | \$313.0  | \$328.9 |         |
| Reestimated reinsurance recoverables - latest.....  | 28.9    | 33.9    | 33.1    | 43.1      | 43.0      | 43.9      | 46.9      | 49.5      | 29.9     | 32.7    |         |
| Net Reserve reestimated - latest (1).....   | \$238.6 | \$244.4 | \$245.0 | \$257.1   | \$268.1   | \$277.9   | \$298.5   | \$297.9   | \$283.1  | \$296.2 |         |
| Gross cumulative excess (deficiency) (2).....   | \$ 81.6 | \$ 40.4 | \$ 11.0 | \$ (24.6) | \$ (39.9) | \$ (49.7) | \$ (69.7) | \$ (71.7) | \$ (8.7) | \$ 6.1  |         |

(1) Reserves net of anticipated reinsurance recoverables ("Net Reserves"). Net Reserves is a measure used by the Company's management to evaluate the overall adequacy of the property and casualty loss reserves and management believes it provides an alternative view of the Company's anticipated liabilities after reflecting expected recoveries from its reinsurers. This is considered a non-GAAP financial measure under applicable SEC rules because it is not displayed as a separate item in the Consolidated Balance Sheets. For balance sheet reporting, GAAP does not permit the Company to offset expected reinsurance recoveries against liabilities, yet management believes it is useful to investors to take these expected recoveries into account. These adjustments only affect the classification of these items in the Consolidated Balance Sheets and the Consolidated Statements of Cash Flows and there is no impact on the Company's benefits, claims and settlement expenses incurred as reported in the Consolidated Statements of Operations.

(2) For discussion of the reserve development, see "Notes to Consolidated Financial Statements -- Note 3 -- Property and Casualty Unpaid Claims and Claim Expenses" listed on page F-1 of this report.

### *Property and Casualty Reinsurance*

All reinsurance is obtained through contracts which generally are renewed each calendar year. Although reinsurance does not legally discharge the Company from primary liability for the full amount of its policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded. Historically, the Company's losses from uncollectible reinsurance recoverables have been insignificant due to the Company's emphasis on the credit worthiness of its reinsurers. Past due reinsurance recoverables as of December 31, 2005 were insignificant.

Through 2005, the Company maintained an excess and catastrophe treaty reinsurance program. Effective January 1, 2005, the Company reinsured 95% of catastrophe losses above a retention of \$10.0 million per occurrence up to \$80.0 million per occurrence. The catastrophe treaty coverage consisted of four layers, each of which provided for one mandatory reinstatement. The four layers were \$5.0 million excess of \$10.0 million, \$10.0 million excess of \$15.0 million, \$15.0 million excess of \$25.0 million and \$40.0 million excess of \$40.0 million. In addition, the Company's predominant insurance subsidiary for property and casualty business written in Florida reinsures 90% of hurricane losses in that state above an estimated retention of \$13.2 million up to \$60.9 million with the Florida Hurricane Catastrophe Fund ("FHCF"), based on the FHCF's financial resources. The FHCF contract is a one-year contract, effective June 1. Through May 7, 2005, these catastrophe reinsurance programs were augmented by a \$75.0 million equity put and reinsurance agreement, as further discussed below.

During 2005, the Company experienced significant losses from four hurricanes, two of which -- Katrina and Rita -- resulted in substantial catastrophe treaty reinsurance recoveries. As a result of reinsurance claims from these two hurricanes, the first layer of the catastrophe treaty was exhausted and the second layer had \$2.5 million of remaining coverage.

Effective January 1, 2006, the Company purchased both catastrophe excess of loss and catastrophe aggregate reinsurance coverage. The excess of loss coverage consists of two contracts in addition to the FHCF. The primary contract provides 95% coverage of catastrophe losses above a retention of \$15.0 million per occurrence up to \$110.0 million per occurrence. This contract consists of four layers, each of which provide for one mandatory reinstatement. The four layers are \$10.0 million excess of \$15.0 million, \$20.0 million excess of \$25.0 million, \$30.0 million excess of \$45.0 million, and \$35.0 million excess of \$75.0 million. The other excess of loss contract provides 95% coverage of catastrophe losses above a retention of \$10.0 million per occurrence up to \$15.0 million per occurrence, after the Company retains \$5.0 million of losses above \$10.0 million for the first occurrence. This contract also provides for one mandatory reinstatement. The FHCF limits described above continue through June 1, 2006, at which time a new annual contract begins. The catastrophe aggregate contract provides 95% coverage of the Company's 2006 catastrophe losses, capped at \$10.0 million per occurrence, above an annual retention of \$20.0 million, up to an annual limit of \$40.0 million.

Effective May 7, 2002, the Company entered into a 36-month equity put and reinsurance agreement with a subsidiary of Swiss Reinsurance Company, which provided a source of up to \$75 million of contingent capital for catastrophe losses above the Company's reinsurance coverage limits. Due to relatively unfavorable pricing and terms, the Company elected not to renew this agreement on the May 7, 2005 expiration date. Management believes that the Company's current catastrophe protection as well as other potential sources of capital would be sufficient in the event of excessive catastrophe losses.

The Company has not joined the California Earthquake Authority ("CEA"). The Company's exposure to losses from earthquakes is managed through its underwriting standards, its earthquake policy coverage limits and deductible levels, and the geographic distribution of its business, as well as its reinsurance program. After reviewing the exposure to earthquake losses from its own policies and from participation in the CEA, management believes it is in the Company's best economic interest to offer earthquake coverage directly to its homeowners policyholders.

For liability coverages, including the educator excess professional liability policy, the Company reinsures each loss above a retention of \$500,000 up to \$20 million. For property coverages, the Company reinsures each loss above a retention of \$500,000 up to \$2.5 million, including catastrophe losses that in the aggregate are less than the retention levels above.

The following table identifies the Company's most significant reinsurers under the traditional catastrophe reinsurance program, their percentage participation in the Company's aggregate reinsured catastrophe coverage and their rating by A.M. Best Company ("A.M. Best") and Standard & Poor's Corporation ("S&P" or "Standard & Poor's") as of January 1, 2006. No other single reinsurer's percentage participation in 2006 or 2005 exceeds 5%.

**Property Catastrophe Reinsurance Participants In Excess of 5%**

| A.M. Best<br>Rating | S&P<br>Rating | Reinsurer                               | Parent                                | Participation |      |
|---------------------|---------------|---|---------------------------------------|---------------|------|
|                     |               |   |                                       | 2006          | 2005 |
| A+                  | AA            | Swiss Re Underwriters Agency            | Swiss Reinsurance Company             | 13%           | 0%   |
| A-                  | AA-           | AXA Re                                  | AXA Group                             | 10%           | 7%   |
| A-                  | NR            | New Castle Reinsurance Company,<br>Ltd. | Citadel Investment Group, L.L.C.      | 9%            | 0%   |
| A++                 | AA            | Harbor Point Re                         | The Chubb Corporation                 | 7%            | 0%   |
| A+                  | AA-           | Tokio Millennium Re Ltd.                | Millea Holdings Inc.                  | 7%            | 0%   |
| A                   | A             | Liberty Syndicate Management<br>Limited | Liberty Mutual Holding Company, Inc.  | 5%            | 8%   |
| A+                  | A+            | IPCRe, Ltd.                             | IPC Holdings, Ltd.                    | *             | 17%  |
| A                   | AA-           | Mapfre Reinsurance Corporation          | Sistema MAPFRE                        | *             | 12%  |
| A                   | A-            | Montpelier Reinsurance Ltd.             | Montpelier Re Holdings, Ltd.          | 0%            | 9%   |
| A-                  | NR            | Rosemont Reinsurance Limited            | Goshawk Insurance Holdings plc        | 0%            | 8%   |
| A+                  | AA            | Transatlantic Reinsurance Company       | American International Group, Inc.    | *             | 7%   |
| A                   | A             | Axis Specialty Limited                  | Axis Capital Holdings Limited         | 0%            | 6%   |
| A+                  | NR            | Allied World Assurance Company,<br>Ltd. | Allied World Assurance Holdings, Ltd. | 0%            | 6%   |

\* Less than 5%  
NR Not rated.

For 2006, property catastrophe reinsurers representing 100% of the Company's aggregate reinsured catastrophe coverage were rated "A- (Excellent)" or above by A.M. Best.

## Annuity Segment

Educators in the Company's target market benefit from the provisions of Section 403(b) of the Internal Revenue Code. This section of the Code allows public school employees and employees of other tax-exempt organizations, such as not-for-profit private schools, to reduce their pretax income by making periodic contributions to an individual qualified retirement plan. The Company is one of the largest participants in the 403(b) tax-qualified annuity market, measured by 403(b) net written premium on a statutory accounting basis. The Company has approved 403(b) payroll reduction capabilities in approximately one-third of the 14,000 public school districts in the U.S. Approximately 65% of the Company's new annuity contract deposits in 2005 were for 403(b) tax-qualified annuities; approximately 75% of accumulated annuity value on deposit is 403(b) tax-qualified. In 2005, annuities represented 33% of the Company's total insurance premiums written and contract deposits.

The Company markets tax-qualified annuities primarily under a contract which allows the contractholder to allocate funds to both fixed and variable alternatives. The features of the Company's annuity contract contribute to business retention. Under the fixed account option, both the principal and a rate of return are guaranteed. Contractholders can change at any time their allocation of deposits between the guaranteed interest rate fixed account and available variable investment options.

The Company's 48 variable account options include funds managed by some of the best-known names in the mutual fund industry, such as Wilshire, Fidelity, JP Morgan, T. Rowe Price, Neuberger Berman, AllianceBernstein, Ranier, Davis, Credit Suisse, BlackRock, Goldman Sachs, Dreyfus, Templeton, Ariel, Wells Fargo, Royce, Lord Abbett and Delaware, offering the Company's customers multiple investment options, regardless of their personal investment objectives and risk tolerance. Total accumulated fixed and variable annuity cash value on deposit at December 31, 2005 was \$3.3 billion.

In 2003, to assist agents in delivering the Value Proposition, the Company entered into a third-party vendor agreement with American Funds Distributors, Inc. ("AFD") to market their retail mutual funds. In addition to retail mutual funds accounts, the Company's agents can also offer a 529 college savings program and Coverdell Education Savings Accounts through this marketing alliance. In 2005, the Company further expanded its product offerings to include equity indexed annuities and single premium immediate annuities through additional marketing alliances. These third-party vendors underwrite these accounts and the Company receives commissions on the sales of these products.

## Selected Historical Financial Information For Annuity Segment

The following table sets forth certain information with respect to the Company's annuity products for the periods indicated.

### Annuity Segment Selected Historical Financial Information

(Dollars in millions, unless otherwise indicated)

|  | Year Ended December 31, |                   |                   |
|--|-------------------------|-------------------|-------------------|
|  | 2005                    | 2004              | 2003              |
| <b>Statement of Operations Data:</b>   |                         |                   |                   |
| Contract deposits:   |                         |                   |                   |
| Variable .....   | \$ 137.8                | \$ 132.0          | \$ 115.3          |
| Fixed .....  | 182.3                   | 195.0             | 181.3             |
| Total .....  | 320.1                   | 327.0             | 296.6             |
| Contract charges earned .....  | 17.9                    | 16.7              | 14.6              |
| Net investment income .....  | 112.9                   | 109.4             | 104.4             |
| Net interest margin (without realized gains) .....   | 31.4                    | 33.7              | 33.1              |
| Income before income taxes .....   | 16.3                    | 16.3              | 19.8              |
| Net income .....   | 15.1                    | 12.6              | 14.4              |
| <b>Operating Statistics:</b>   |                         |                   |                   |
| Fixed:   |                         |                   |                   |
| Accumulated value .....  | \$ 1,961.7              | \$ 1,826.2        | \$ 1,650.6        |
| Accumulated value persistency .....  | 94.5%                   | 95.5%             | 95.1%             |
| Variable:  |                         |                   |                   |
| Accumulated value .....  | \$ 1,333.7              | \$ 1,254.8        | \$ 1,119.2        |
| Accumulated value persistency .....  | 91.5%                   | 92.9%             | 92.8%             |
| Number of contracts in force .....   | 162,417                 | 158,703           | \$152,515         |
| Average accumulated cash value (in dollars) .....  | \$ 20,290               | \$ 19,414         | \$ 18,161         |
| Average annual deposit by contractholders (in dollars) .....                                     | \$ 2,436                | \$ 2,391          | \$ 2,303          |
| Annuity contracts terminated due to surrender, death,<br>maturity or other:                      |                         |                   |                   |
| Number of contracts .....  | 7,938                   | 6,918             | 7,019             |
| Amount .....   | \$ 243.6                | \$ 200.5          | \$ 171.3          |
| Fixed accumulated cash value grouped<br>by applicable surrender charge:                          |                         |                   |                   |
| 0% .....   | \$ 530.8                | \$ 510.7          | \$ 478.3          |
| Greater than 0% but less than 5% .....   | 78.3                    | 69.1              | 50.3              |
| 5% and greater but less than 10% .....   | 1,226.7                 | 1,106.4           | 968.3             |
| 10% and greater .....  | 18.8                    | 35.2              | 54.3              |
| Supplementary contracts with life contingencies<br>not subject to discretionary withdrawal ..... | 107.1                   | 104.8             | 99.4              |
| Total .....  | <u>\$ 1,961.7</u>       | <u>\$ 1,826.2</u> | <u>\$ 1,650.6</u> |

## Life Segment

The Company entered the individual life insurance business in 1949 with traditional term and whole life insurance products. The Company's traditional term, whole life and group life business in force consists of approximately 157,000 policies, representing approximately \$7.8 billion of life insurance in force with annual insurance premiums and contract deposits of approximately \$42.6 million as of December 31, 2005. The Company also underwrites "Experience Life", a flexible, adjustable-premium life insurance contract which allows the customer to combine elements of term life insurance, interest-sensitive whole life insurance and an interest-bearing account. At December 31, 2005, the Company had in force approximately 80,000 Experience Life policies representing approximately \$5.3 billion of life insurance in force with annual insurance premiums and contract deposits of approximately \$62.7 million.

In 2005, the life segment represented 11% of the Company's total insurance premiums written and contract deposits, including approximately 1 percentage point attributable to the Company's group life and group disability income business.

During 2005, the average face amount of ordinary life insurance policies issued by the Company was \$159,825 and the average face amount of all ordinary life insurance policies in force at December 31, 2005 was \$65,550.

The maximum individual life insurance risk retained by the Company is \$200,000 on any individual life and \$100,000 or \$125,000 is retained on each group life policy depending on the type of coverage. The excess of the amounts retained are reinsured with life reinsurers that are all rated "A- (Excellent)" or above by A.M. Best. The Company also maintains a life catastrophe reinsurance program. The Company reinsures 100% of the catastrophe risk in excess of \$1 million up to \$15 million per occurrence. This program covers acts of terrorism but excludes nuclear, biological and chemical explosions as well as other acts of war.

In 2000, the Company instituted a program to offer long-term care and variable universal life policies with two third-party vendors underwriting such insurance. In 2003, the Company expanded its third-party vendor offerings with the addition of fixed interest rate universal life insurance underwritten by Jefferson Pilot Financial. Under these programs, the third-party vendors underwrite and bear the risk of these insurance policies and the Company receives a commission on the sale of that business.

## Selected Historical Financial Information For Life Segment

The following table sets forth certain information with respect to the Company's life products for the periods indicated.

### Life Segment Selected Historical Financial Information

(Dollars in millions, unless otherwise indicated)

|  | Year Ended December 31, |                  |                  |
|--|-------------------------|------------------|------------------|
|  | 2005                    | 2004             | 2003             |
| <b>Statement of Operations Data:</b>   |                         |                  |                  |
| Insurance premiums and contract deposits .....                                 | \$ 105.6                | \$ 109.1         | \$ 112.4         |
| Insurance premiums and contract charges earned .....                           | 97.4                    | 96.7             | 95.1             |
| Net investment income .....  | 49.3                    | 49.5             | 49.6             |
| Income before income taxes .....   | 22.3                    | 22.0             | 20.8             |
| Net income .....   | 13.4                    | 14.8             | 13.4             |
| <b>Operating Statistics:</b>   |                         |                  |                  |
| Life insurance in force:   |                         |                  |                  |
| Ordinary life .....  | \$ 11,588               | \$ 11,509        | \$ 11,527        |
| Group life .....   | 1,554                   | 1,714            | 1,736            |
| Total .....  | <u>\$ 13,142</u>        | <u>\$ 13,223</u> | <u>\$ 13,263</u> |
| Number of policies in force:   |                         |                  |                  |
| Ordinary life .....  | 176,780                 | 182,022          | 187,533          |
| Group life .....   | 60,674                  | 69,621           | 70,725           |
| Total .....  | <u>237,454</u>          | <u>251,643</u>   | <u>258,258</u>   |
| Average face amount in force (in dollars):                                     |                         |                  |                  |
| Ordinary life .....  | \$ 65,550               | \$ 63,229        | \$ 61,467        |
| Group life .....   | 25,612                  | 24,619           | 24,546           |
| Total .....  | 55,345                  | 52,547           | 51,356           |
| Lapse ratio (ordinary life insurance in force) .....                           | 6.5%                    | 7.2%             | 7.7%             |
| Ordinary life insurance terminated due to death,<br>surrender, lapse or other: |                         |                  |                  |
| Face amount of insurance surrendered or lapsed .....                           | \$ 733.4                | \$ 842.5         | \$ 932.6         |
| Number of policies .....   | 6,941                   | 8,078            | 7,466            |
| Amount of death claims opened .....  | \$ 33.7                 | \$ 31.1          | \$ 32.0          |
| Number of death claims opened .....  | 1,310                   | 1,273            | 1,292            |

## Investments

The Company's investments are selected to balance the objectives of protecting principal, minimizing exposure to interest rate risk and providing a high current yield. These objectives are implemented through a portfolio that emphasizes investment grade, publicly traded fixed income securities. When impairment of the value of an investment is considered other than temporary, the decrease in value is recorded as a charge to the results of operations and a new cost basis is established. At December 31, 2005, investments in non-investment grade securities represented 5.1% of total investments. At December 31, 2005, fixed income securities represented 97.4% of investments excluding securities lending collateral. Of the fixed income investment portfolio, 94.4% was investment grade and 99.9% was publicly traded. At December 31, 2005, the average quality and average option adjusted duration of the total fixed income portfolio were A+ and 5.5 years, respectively. There are no significant investments in mortgage loans, real estate, foreign securities, privately placed securities, or common or preferred stocks.

The Company has separate investment strategies and guidelines for its property and casualty assets and for its life and annuity assets, which recognize different characteristics of the associated insurance liabilities, as well as different tax and regulatory environments. The Company manages interest rate exposure for its portfolios through asset/liability management techniques which attempt to coordinate the duration of the assets with the duration of the insurance policy liabilities. Duration of assets and liabilities will generally differ only because of

opportunities to significantly increase yields or because policy values are not interest-sensitive, as is the case in the property and casualty segment.

The investments of each insurance subsidiary must comply with the insurance laws of such insurance subsidiary's domiciliary state. These laws prescribe the type and amount of investments that may be purchased and held by insurance companies. In general, these laws permit investments, within specified limits and subject to certain qualifications, in federal, state and municipal obligations, corporate bonds, mortgage-backed bonds, other asset-backed bonds, preferred stocks, common stocks, real estate mortgages and real estate.

The following table sets forth the carrying values and amortized cost of the Company's investment portfolio as of December 31, 2005:

| <b>Investment Portfolio</b>  |   |                  |                     |                          |                   |
|--|---|------------------|---------------------|--------------------------|-------------------|
| (Dollars in millions)  |   |                  |                     |                          |                   |
|  | Percentage<br>of Total<br>Carrying<br>Value | Carrying Value   |                     |                          | Amortized<br>Cost |
|  |   | Total            | Life and<br>Annuity | Property and<br>Casualty |                   |
| <b>Publicly Traded Fixed Maturity Securities<br/>and Cash Equivalents:</b> |   |                  |                     |                          |                   |
| U.S. government and agency obligations (1):                                |   |                  |                     |                          |                   |
| Mortgage-backed securities.....  | 17.3%                                       | \$ 690.2         | \$ 660.9            | \$ 29.3                  | \$ 700.1          |
| Other.....   | 6.8   | 272.2            | 235.1               | 37.1                     | 273.6             |
| Investment grade corporate and public<br>utility bonds.....                | 44.8  | 1,789.3          | 1,734.2             | 55.1                     | 1,738.6           |
| Municipal bonds.....   | 14.4  | 576.8            | 49.6                | 527.2                    | 571.2             |
| Other mortgage-backed securities.....                                      | 3.5   | 138.0            | 118.9               | 19.1                     | 138.0             |
| Non-investment grade corporate and public<br>utility bonds (2).....        | 5.1   | 203.2            | 136.8               | 66.4                     | 201.7             |
| Foreign government bonds.....  | 0.8   | 31.3             | 29.4                | 1.9                      | 29.8              |
| Short-term investments (3).....  | 0.2   | 8.6              | 7.1                 | 1.5                      | 8.6               |
| Short-term investments, loaned<br>securities collateral (3).....           | 4.8   | 193.0            | 184.7               | 8.3                      | 193.0             |
| Total publicly traded securities.....                                      | <u>97.7</u>                                 | <u>3,902.6</u>   | <u>3,156.7</u>      | <u>745.9</u>             | <u>3,854.6</u>    |
| <b>Other Investments:</b>  |   |                  |                     |                          |                   |
| Private placements, investment grade (4).....                              | -   | 2.2              | 2.2                 | -                        | 2.2               |
| Private placements,<br>non-investment grade (2) (4).....                   | -   | 0.1              | 0.1                 | -                        | 0.1               |
| Mortgage loans (5).....  | 0.1   | 3.6              | 3.6                 | -                        | 3.6               |
| Policy loans and other.....  | 2.2   | 88.0             | 85.1                | 2.9                      | 87.9              |
| Total other investments.....   | <u>2.3</u>                                  | <u>93.9</u>      | <u>91.0</u>         | <u>2.9</u>               | <u>93.8</u>       |
| Total investments (6).....   | <u>100.0%</u>                               | <u>\$3,996.5</u> | <u>\$3,247.7</u>    | <u>\$748.8</u>           | <u>\$3,948.4</u>  |

- (1) Includes \$206.0 million fair value of investments guaranteed by the full faith and credit of the U.S. government and \$756.4 million fair value of federally sponsored agency securities.
- (2) A non-investment grade rating is assigned to a security when it is acquired, primarily on the basis of the Standard & Poor's Corporation ("Standard & Poor's" or "S&P") rating for such security, or if there is no S&P rating, the Moody's Investors Service, Inc. ("Moody's") rating for such security, or if there is no S&P or Moody's rating, the National Association of Insurance Commissioners' (the "NAIC") rating for such security. The rating agencies monitor securities, and their issuers, regularly and make changes to the ratings as necessary. The Company incorporates rating changes on a monthly basis.
- (3) Short-term investments mature within one year of being acquired and are carried at cost, which approximates fair value. Short-term investments represent \$9.1 million in money market funds rated "AAA" and \$192.5 million in repurchase agreements and commercial paper maturing on January 3, 2006. The Company loans fixed income securities to third parties, primarily major brokerage firms. The Company separately maintains a minimum of 100% of the market value of the loaned securities as collateral for each loan.
- (4) Fair values for private placements are estimated by the Company with the assistance of its investment advisors.
- (5) Mortgage loans are carried at amortized cost or unpaid principal balance.
- (6) Approximately 9% of the Company's investment portfolio, having a carrying value of \$358.2 million as of December 31, 2005, consisted of securities with some form of credit support, such as insurance. All of these securities with credit support have the highest investment grade rating.

## Fixed Maturity Securities

The following table sets forth the composition of the Company's fixed maturity securities portfolio by rating as of December 31, 2005:

### Rating of Fixed Maturity Securities (1)

(Dollars in millions)

|                     | Percent<br>of Total<br>Carrying<br>Value | Carrying<br>Value | Amortized<br>Cost |
|---------------------|--|-------------------|-------------------|
| AAA .....           | 43.3%                                    | \$1,603.2         | \$1,609.0         |
| AA .....            | 7.5                                      | 278.1             | 277.5             |
| A .....             | 24.1                                     | 893.8             | 864.0             |
| BBB .....           | 19.5                                     | 722.6             | 700.8             |
| BB .....            | 2.0                                      | 75.8              | 75.0              |
| B .....             | 3.4                                      | 124.6             | 125.0             |
| CCC or lower .....  | 0.1                                      | 2.9               | 1.7               |
| Not rated (2) ..... | 0.1                                      | 2.3               | 2.3               |
| Total .....         | <u>100.0%</u>                            | <u>\$3,703.3</u>  | <u>\$3,655.3</u>  |

(1) Ratings are as assigned primarily by S&P when available, with remaining ratings as assigned on an equivalent basis by Moody's. Ratings for publicly traded securities are determined when the securities are acquired and are updated monthly to reflect any changes in ratings.

(2) This category includes \$2.3 million of private placement securities not rated by either S&P or Moody's. The NAIC has rated 99.2% of these private placement securities as investment grade.

At December 31, 2005, 34.7% of the Company's fixed maturity securities portfolio was expected to mature within the next 5 years. Mortgage-backed securities, including mortgage-backed securities of U.S. governmental agencies, represented 20.7% of the total investment portfolio at December 31, 2005. These securities typically have average lives shorter than their stated maturities due to unscheduled prepayments on the underlying mortgages. Mortgages are prepaid for a variety of reasons, including sales of existing homes, interest rate changes over time that encourage homeowners to refinance their mortgages and defaults by homeowners on mortgages that are then paid by guarantors.

For financial reporting purposes, the Company has classified the entire fixed maturity portfolio as "available for sale". Fixed maturities to be held for indefinite periods of time and not intended to be held to maturity are classified as available for sale and carried at fair value. The net adjustment for unrealized gains and losses on securities available for sale is recorded as a separate component of shareholders' equity, net of applicable deferred tax asset or liability and the related impact on deferred policy acquisition costs and value of acquired insurance in force associated with interest-sensitive life and annuity contracts. Fixed maturities held for indefinite periods of time include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in interest rates, resultant prepayment risk and other related factors.

## **Cash Flow**

As a holding company, HMEC conducts its principal operations through its subsidiaries. Payment by HMEC of principal and interest with respect to HMEC's indebtedness, and payment by HMEC of dividends to its shareholders, are dependent upon the ability of its insurance subsidiaries to pay cash dividends or make other cash payments to HMEC, including tax payments pursuant to tax sharing agreements. Restrictions on the subsidiaries' ability to pay dividends or to make other cash payments to HMEC may materially affect HMEC's ability to pay principal and interest on its indebtedness and dividends on its common stock.

The ability of the insurance subsidiaries to pay cash dividends to HMEC is subject to state insurance department regulations which generally permit dividends to be paid for any 12 month period in amounts equal to the greater of (i) net income for the preceding calendar year or (ii) 10% of surplus as of the preceding December 31st. Any dividend in excess of these levels requires the prior approval of the Director or Commissioner of the state insurance department of the state in which the dividend paying insurance subsidiary is domiciled. The aggregate amount of dividends that may be paid in 2006 from all of HMEC's insurance subsidiaries without prior regulatory approval is approximately \$74 million.

Notwithstanding the foregoing, if insurance regulators otherwise determine that payment of a dividend or any other payment to an affiliate would be detrimental to an insurance subsidiary's policyholders or creditors, because of the financial condition of the insurance subsidiary or otherwise, the regulators may block dividends or other payments to affiliates that would otherwise be permitted without prior approval.

## **Competition**

The Company operates in a highly competitive environment. The insurance industry consists of a large number of insurance companies, some of which have substantially greater financial resources, more diversified product lines, and lower cost marketing approaches compared to the Company, such as direct marketing, mail, Internet and telemarketing.

The Company competes in its target market with a number of national providers of personal automobile, homeowners and life insurance such as State Farm, Allstate, Farmers and Nationwide as well as several regional companies. The Company also competes for automobile business with other companies such as American International Group ("AIG"), GEICO, Progressive and USAA, many of which feature direct marketing distribution.

The market for tax-deferred annuity products has seen heightened competition from entrants such as mutual funds and banks. Among the major national providers of annuities to educators, Variable Annuity Life Insurance Company ("VALIC"), a subsidiary of AIG, is one of the Company's major tax-qualified annuity competitors. ING US Financial Services, MetLife and Security Benefit are also significant national providers of 403(b) annuities and competitors of the Company. Mutual fund families, independent agent companies and financial planners also compete in this marketplace.

## Regulation

### *General Regulation at State Level*

As an insurance holding company, HMEC is subject to extensive regulation by the states in which its insurance subsidiaries are domiciled or transact business. In addition, the laws of the various states establish regulatory agencies with broad administrative powers to grant and revoke licenses to transact business, regulate trade practices, license agents, require statutory financial statements, and prescribe the type and amount of investments permitted.

The NAIC has adopted risk-based capital guidelines to evaluate the adequacy of statutory capital and surplus in relation to an insurance company's risks. State insurance regulations prohibit insurance companies from making any public statements or representations with regard to their risk-based capital levels. Based on current guidelines, the risk-based capital statutory requirements are not expected to have a negative regulatory impact on the Company's insurance subsidiaries.

### *Assessments Against Insurers*

Under insurance insolvency or guaranty laws in most states in which the Company operates, insurers doing business therein can be assessed for policyholder losses related to insolvencies of other insurance companies. The amount and timing of any future assessments on the Company under these laws cannot be reasonably estimated and are beyond the control of the Company. Most of these laws do provide, however, that an assessment may be excused or deferred if it would threaten an insurer's financial strength, and many assessments paid by the Company pursuant to these laws may be used as credits for a portion of the Company's premium taxes in certain states. For the three years ended December 31, 2005, the Company's assessments, net of the related premium tax credits, were not significant.

### *Mandatory Insurance Facilities*

The Company is required to participate in various mandatory insurance facilities in proportion to the amount of the Company's direct writings in the applicable state. In 2005, the Company reflected a net loss from participation in such mandatory pools and underwriting associations of \$2.4 million before federal income taxes, primarily as a result of assessments following hurricanes in 2005 and 2004.

In 2005 the Company paid \$3.1 million in additional assessments related to hurricanes which occurred in 2005 and 2004 and these payments are reflected in the \$2.4 million net loss reported above. The Citizens Property Insurance Corporation of Florida assessed the Company \$1.8 million and the Louisiana Citizens Fair and Coastal Plan assessed the Company \$1.3 million. The Company will in turn assess its policyholders in the respective states to recoup these amounts. See also "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Results of Operations for the Three Years Ended December 31, 2005 -- Insurance Premiums and Contract Charges".

## *Regulation at Federal Level*

Although the federal government generally does not directly regulate the insurance industry, federal initiatives often impact the insurance business. Current and proposed federal measures which may significantly affect insurance and annuity business include employee benefits regulation, controls on the costs of medical care, medical entitlement programs such as Medicare, structure of retirement plans and accounts, changes to the insurance industry anti-trust exemption, and minimum solvency requirements. Other federal regulation such as the Fair Credit Reporting Act, Gramm-Leach-Bliley Act, Privacy Act and USA PATRIOT Act, including its anti-money laundering regulations, also impact the Company's business.

The variable annuities underwritten by HMLIC are regulated by the SEC. Horace Mann Investors, Inc., the broker-dealer subsidiary of HMEC, also is regulated by the SEC, the NASD, the Municipal Securities Rule-making Board ("MSRB") and various state securities regulators.

Federal income taxation of the build-up of cash value within a life insurance policy or an annuity contract could have a materially adverse impact on the Company's ability to market and sell such products. Various legislation to this effect has been proposed in the past, but has not been enacted. Although no such legislative proposals are known to exist at this time beyond the proposal described below, such proposals may be made again in the future.

Changes in other federal and state laws and regulations could also affect the relative tax and other advantages of the Company's life and annuity products to customers. For instance, in late 2004, the Internal Revenue Service ("IRS") issued proposed regulations regarding Section 403(b) arrangements, including annuities. The proposed regulations would alter the nature of 403(b) arrangements to an employer-sponsored plan, compared to the historical view of 403(b) arrangements being individual plans funded by salary reduction. If adopted, the Company, and many other providers of 403(b) arrangements, would need to adapt its product and services offered to better meet the changing needs of the school district sponsors of those arrangements and modify its administrative systems to support these changes. The issuance of final regulations had been expected in 2005 with an effective date of January 1, 2006. Both the timing and the nature of the proposed regulations have come under heavy criticism from school administrators, teachers, and providers of 403(b) arrangements and final regulations were not issued in 2005. It is now anticipated that the IRS will issue final regulations in 2006 with an effective date no earlier than January 1, 2007. At the time of this Annual Report on Form 10-K, the final form of any changes, their timing or their impact on the 403(b) market is unknown.

In recent years, the state insurance regulatory framework has come under public scrutiny and members of Congress have discussed proposals to provide for optional federal chartering of insurance companies. Although no such legislative proposals are known to exist at the time of this Annual Report on Form 10-K, proposals of this nature may be made in the future.

## **Employees**

At December 31, 2005, the Company had approximately 2,400 employees, including 855 full-time agents. The Company has no collective bargaining agreement with any employees.

## ITEM 1A. Risk Factors

The following are certain risk factors that could affect the Company's business, financial results and results of operations. In addition, refer to the risk factors disclosed in "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Forward-looking Information", listed on page F-1 of this report for certain important factors that may cause our financial condition and results of operations to differ materially from current expectations. The risks that the Company has highlighted in these two sections of this report are not the only ones that the Company faces. In this discussion, the Company is also referred to as "our", "we" and "us".

***Our markets are highly competitive and our financial condition and results of operations may be adversely affected if we do not remain competitive.***

We operate in a highly competitive environment and compete with numerous insurance companies, as well as mutual fund families, independent agent companies and financial planners. In some instances and geographic locations, competitors have specifically targeted the educator marketplace with specialized products and programs. We compete in our target market with a number of national providers of personal automobile and homeowners insurance and life insurance and annuities.

The insurance industry consists of a large number of insurance companies, some of which have substantially greater financial resources, more diversified product lines and lower cost marketing approaches, such as direct marketing, mail, Internet and telemarketing, compared to us. In our target market, we believe that the principal competitive factors in the sale of property and casualty insurance products are price, service, name recognition and education association sponsorships. We believe that the principal competitive factors in the sale of life insurance and annuity products are product features, perceived stability of the insurer, service, name recognition, education association sponsorships and price.

Particularly in the property and casualty business, our insurance subsidiaries have experienced, and expect to experience in the future, periods of intense competition during which they are unable to increase prices sufficiently to cover costs. The inability of an insurance subsidiary to compete successfully in the property and casualty business would adversely affect its financial condition and results of operations and its resulting ability to distribute cash to us.

For our annuity business, in addition to insurance companies, mutual funds and banks are increasingly strong competitors in the 403(b) and tax deferred annuity products markets. The inability of an insurance subsidiary to compete successfully in these markets would adversely affect its financial condition and results of operations and its resulting ability to distribute cash to us.

***Our financial condition and results of operations may be adversely affected by declining market conditions.***

Conditions in the U.S. and international financial markets affect the sale and profitability of our variable annuities. In general, sales of variable annuities decrease when financial markets are declining over an extended period of time. Therefore, weak financial market performance may adversely affect sales of our variable annuity products to potential customers and may cause current customers to withdraw or reduce the amounts invested in our variable annuity products, in

turn reducing the amount of variable annuity fee revenues generated as well. In addition, some of our variable annuity contracts offer guaranteed minimum death benefits features, which provide for a benefit if the annuitant dies and the contract value is less than a specified amount. A decline in the financial markets could cause the contract value to fall below this specified amount, increasing our exposure to losses from variable annuity products featuring guaranteed minimum death benefits.

***If we are not able to effectively develop and expand our agent force and independent agent distribution systems, as well as maintain and secure product sponsorships by local, state and national education associations, our financial condition and results of operations could be adversely affected.***

Our success in marketing and selling our products is largely dependent upon the efforts of our exclusive sales force of full-time employee agents and, to a lesser degree, our independent agents. As we expand our business, we may need to expand our network of agents to market our products. If we are unable to hire additional agents or if we fail to retain our current agents, sales of our products would likely decline and our financial condition and results of operations would be adversely affected.

In addition, one of the keys to the successful sale of our 403(b) tax-qualified annuity products is our ability to obtain payroll reduction authorization from school districts and product sponsorships from local, state and national education associations. In late 2004, the IRS issued proposed regulations regarding Section 403(b) arrangements, including annuities. The proposed regulations would alter the nature of 403(b) arrangements to an employer-sponsored plan. This would be a potentially significant change from the historical view of 403(b) arrangements being individual plans funded by salary reduction. This could prompt school district sponsors of 403(b) arrangements to reconsider the companies permitted to offer products to fund such arrangements within their district, and potentially reduce the number of authorized providers. Such actions present the threat of losing certain current payroll reduction authorizations and sponsorships, and the potential for lost sales and resulting revenues in those school districts, as well as the opportunity to increase penetration in school districts where the Company remains as one of a reduced number of approved providers. If these proposed regulations are adopted, our ability to maintain and grow our share of the 403(b) market will depend on our ability to successfully adapt our products, services offered, and administrative systems, which could potentially increase the Company's cost of doing business in this market. At the time of this Annual Report on Form 10-K, we anticipate that the proposed changes would not occur prior to January 1, 2007. Also, the final form of any changes, their timing or their impact on the 403(b) market is unknown.

***Certain changes in accounting or financial reporting standards issued by the Financial Accounting Standards Board, the Securities and Exchange Commission or other standard-setting bodies may have an adverse effect on our financial condition, results of operations and/or cost of doing business.***

Our consolidated financial statements are subject to the application of U.S. generally accepted accounting principles, or GAAP, which is periodically revised and/or expanded. Accordingly, we are required to adopt new or revised accounting standards issued by recognized authoritative bodies, including the Financial Accounting Standards Board and the Securities and Exchange Commission. It is possible that future changes in accounting standards may impact the current accounting treatment applied in our consolidated financial statements and that such changes could have a material adverse effect on our financial condition and results of operations. For a description of potential changes in accounting standards that could affect us currently, see

"Management's Discussion and Analysis of Financial Condition and Results of Operations -- Recent Accounting Changes" listed on page F-1 of this report.

***Our property and casualty loss reserves may not be adequate.***

Our property and casualty insurance subsidiaries maintain loss reserves to provide for their estimated ultimate liability for losses and loss adjustment expenses with respect to reported and unreported claims incurred as of the end of each accounting period. If these loss reserves prove inadequate, we will record a loss measured by the amount of the shortfall and, as a result, the financial condition and results of operations of our insurance subsidiaries will be adversely affected, potentially affecting their ability to distribute cash to us.

Reserves do not represent an exact calculation of liability. Reserves represent estimates, generally involving actuarial projections at a given time, of what our insurance subsidiaries expect the ultimate settlement and adjustment of claims will cost, net of salvage and subrogation. Estimates are based on assessments of known facts and circumstances, assumptions related to the ultimate cost to settle such claims, estimates of future trends in claims severity and frequency, changing judicial theories of liability and other factors. These variables are affected by both internal and external events, including changes in claims handling procedures, economic inflation, unpredictability of court decisions, plaintiffs' expanded theories of liability, risks inherent in major litigation and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. Significant reporting lags may exist between the occurrence of an insured event and the time it is actually reported. Our insurance subsidiaries adjust their reserve estimates regularly as experience develops and further claims are reported and settled.

Due to inherent uncertainty in estimating reserves for losses and loss adjustment expenses, we cannot be certain that the ultimate liability will not exceed amounts reserved, with a resulting adverse effect on our financial condition and results of operations.

***Inaccuracies in assumptions regarding future persistency, mortality, morbidity and interest rates used in calculating life and annuity reserve and deferred policy acquisition expense amounts could have a material adverse impact on our net income.***

The process of calculating reserve and deferred policy acquisition expense amounts for our life and annuity businesses involve the use of a number of assumptions, including those related to persistency (how long a contract stays with the company), mortality (the relative incidence of death over a given period of time), morbidity (the relative incidence of disability resulting from disease or physical impairment) and interest rates (the rates expected to be paid or received on financial instruments, including insurance or investment contracts). We periodically review the adequacy of these reserves and deferred policy acquisition expenses on an aggregate basis and, if future experience differs significantly from assumptions, adjustments to reserves and deferred policy acquisition expenses may be required which could have a material adverse effect on our financial condition and results of operations.

***Catastrophic events can have a material adverse effect on our financial condition and results of operations.***

Results of property and casualty insurers are subject to weather and other conditions prevailing in an accident year. While one year may be relatively free of major weather or other disasters, another year may have numerous such events causing results for such a year to be materially worse than for other years.

Our insurance subsidiaries have experienced, and we anticipate that in the future they will continue to experience, catastrophe losses. A catastrophic event or a series of multiple catastrophic events could have a material adverse effect on the financial condition and results of operations of our insurance subsidiaries.

Various events can cause catastrophes, including hurricanes, windstorms, earthquakes, hail, terrorism, explosions, severe winter weather and fires. The frequency and severity of these catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposures in the area affected by the event and the severity of the event. Although catastrophes can cause losses in a variety of property and casualty lines, most of the catastrophe-related claims of our insurance subsidiaries are related to homeowners' coverages. Our ability to provide accurate estimates of ultimate catastrophe costs is based on several factors, including:

- the proximity of the catastrophe occurrence date to the date of our estimate;
- potential inflation of property repair costs in the affected area; and
- the occurrence of multiple catastrophes in a geographic area over a relatively short period of time.

As of December 31, 2005, approximately 56% of the total annual premiums for the property and casualty business conducted by our insurance subsidiaries were for policies issued in the ten largest states in which our insurance subsidiaries write property and casualty coverage, including certain states in which catastrophe occurrences are relatively common: California, Florida, North Carolina, South Carolina, Louisiana and Texas.

Our insurance subsidiaries seek to reduce their exposure to catastrophe losses through their underwriting strategies and the purchase of catastrophe reinsurance. Nevertheless, reinsurance may prove inadequate if:

- a major catastrophic loss exceeds the reinsurance limit, or
- a series of major catastrophic events in a single year exhaust the existing reinsurance coverage, or
- an insurance subsidiary pays a number of smaller catastrophic loss claims which, individually, fall below the subsidiary's loss retention level.

***Our catastrophe management strategy may adversely affect premium and policy growth.***

As an ongoing practice, but particularly following the significant catastrophic claims from hurricanes in 2005 and 2004, we attempt to manage our exposure to catastrophes. Reductions in property and casualty business written in catastrophe-prone areas may have a negative impact on near-term business growth and earnings.

***Reduction of the statutory surplus of our insurance subsidiaries could adversely affect their ability to write insurance business.***

Insurance companies write business based, in part, upon guidelines including a ratio of premiums to surplus for property and casualty insurance companies and a ratio of reserves to surplus for life insurance companies. If our insurance subsidiaries cannot maintain profitability in the future, they may be required to draw on their surplus in order to pay dividends to us to enable us to meet our financial obligations. As their surplus is reduced by the payment of dividends, continuing losses or both, our insurance subsidiaries' ability to write business and maintain acceptable financial strength ratings could also be reduced. This could have a material adverse effect upon the business volume and profitability of our insurance subsidiaries.

***Any downgrade in the ratings of our insurance subsidiaries could adversely affect our business.***

Claims-paying and financial strength ratings have become an increasingly important factor in establishing the competitive position of insurance companies. Each rating agency reviews its ratings periodically and from time to time may modify its rating criteria including, among other factors, its expectations regarding capital adequacy. A downgrade in the ratings of any of our insurance subsidiaries by a recognized rating agency could result in a substantial loss of business for that subsidiary if policyholders or independent agents move to other companies with higher claims-paying and financial strength ratings. This loss of business could have a material adverse effect on the financial condition and results of operations of that subsidiary.

***Uncollectible reinsurance can have a material adverse effect upon our business volume and profitability.***

Reinsurance is a contract by which one insurer, called a reinsurer, agrees to cover a portion of the losses incurred by a second insurer in the event a claim is made under a policy issued by the second insurer. Our insurance subsidiaries obtain reinsurance to help manage their exposure to property, casualty and life insurance risks. Although a reinsurer is liable to our insurance subsidiaries according to the terms of its reinsurance policy, the insurance subsidiaries remain primarily liable as the direct insurers on all risks reinsured. As a result, reinsurance does not eliminate the obligation of our insurance subsidiaries to pay all claims, and each insurance subsidiary is subject to the risk that one or more of its reinsurers will be unable or unwilling to honor its obligations.

Our insurance subsidiaries cannot guarantee that their reinsurers will pay in a timely fashion, if at all. Reinsurers may become financially unsound by the time that they are called upon to pay amounts due, which may not occur for many years. Additionally, the availability and cost of reinsurance are subject to prevailing market conditions beyond our control. For example, the significant level of losses from hurricanes in 2005 and 2004 and the terrorist attacks of September 11, 2001 have had a significant adverse affect on the reinsurance market.

If one of our insurance subsidiaries is unable to obtain adequate reinsurance at reasonable rates, that insurance subsidiary would have to increase its risk exposure and/or reduce the level of its underwriting commitments, which could have a material adverse effect upon the business volume and profitability of the subsidiary.

***A reduction or elimination of the tax advantages of life and annuity products would adversely affect our operating results.***

A significant part of our annuity business involves fixed and variable 403(b) tax-qualified annuities, which are annuities purchased voluntarily by individuals employed by public school systems or other tax-exempt organizations. Our financial condition and results of operations could be adversely affected by changes in federal and state laws and regulations that affect the relative tax and other advantages of our life and annuity products to customers, including adverse changes in IRS regulations governing 403(b) plans such as those currently being proposed.

Current federal income tax laws generally permit the tax-deferred accumulation of earnings on the premiums paid by the holders of annuities and life insurance products. Taxes, if any, are payable on income attributable to a distribution under the contract for the year in which the distribution is made. From time to time, Congress has considered legislation that would reduce or eliminate the benefit of such deferral of taxation on the accretion of value with life insurance and non-qualified annuity contracts. Enactment of this legislation, including a simplified "flat tax" income structure with an exemption from taxation for investment income, could result in fewer sales of our life insurance and annuity products.

***Losses due to defaults by others could reduce our profitability or negatively affect the value of our investments.***

Third parties that owe us money, securities or other assets may not pay or perform their obligations. These parties may include the issuers whose securities we hold, borrowers under mortgage loans, customers, trading counterparties, counterparties under swaps and other derivative contracts, reinsurers, clearing agents, exchanges, clearing houses and other financial intermediaries. These parties may default on their obligations to us due to bankruptcy, lack of liquidity, downturns in the economy or real estate values, operational failure or other reasons.

The default of a major market participant could disrupt the securities markets or clearance and settlement systems in the U.S. or abroad. A failure of a major market participant could cause some clearance and settlement systems to assess members of that system, including our broker-dealer subsidiary, or could lead to a chain of defaults that could adversely affect us. A default of a major market participant could disrupt various markets, which could in turn cause market declines or volatility and negatively impact our financial condition and results of operations.

***If our investment strategy is not successful, we could suffer unexpected losses.***

The success of our investment strategy is crucial to the success of our business. Specifically, we are subject to:

- *market value risk*, which is the risk that our invested assets will decrease in value due to a change in the yields realized on our assets and prevailing market yields for similar assets, an unfavorable change in the liquidity of the investment or an unfavorable change in the financial prospects or a downgrade in the credit rating of the issuer of the investment;
- *reinvestment risk*, which is the risk that interest rates will decline and funds reinvested will earn less than expected; and
- *liquidity risk*, which is the risk that liabilities are surrendered or mature sooner than anticipated requiring us to sell assets at an undesirable time to provide for policyholder surrenders or withdrawals.

We attempt to control these risks through product pricing, product features and the establishment of policy reserves, but we cannot provide assurance that assets will be properly matched to meet anticipated liabilities or that our investments will provide sufficient returns to enable us to satisfy our guaranteed fixed benefit obligations.

From time to time, we may also enter into foreign currency, interest rate and credit derivatives and other hedging transactions in an effort to manage risks. We cannot provide assurance that we will successfully structure those derivatives and hedges so as to effectively manage these risks. If our calculations are incorrect, or if we do not properly structure our derivatives or hedges, we may have unexpected losses and our assets may not be adequate to meet our needed reserves, which could adversely affect our financial condition and results of operations.

The result of any investment activity is determined to a significant degree by general economic conditions, which may adversely affect the markets for interest rate sensitive securities, including the level and volatility of interest rates and the extent and timing of investor participation in these markets. Unexpected volatility or illiquidity in the markets in which we hold positions could adversely affect us.

Declining financial markets could also cause the value of the investments in our defined benefit pension plan to decrease, resulting in additional pension expense and an increase in required contributions to the defined benefit pension plan.

***If we fail to correct certain material weaknesses in our internal controls or if we fail to maintain an effective system of internal controls once such material weaknesses are corrected, we may not be able to accurately report our financial results.***

Effective internal controls are necessary for us to provide accurate, reliable financial reports. If we cannot provide accurate, reliable financial reports, our investors could be unable to accurately assess our performance and could lose confidence in us, and our financial condition and results of operations could be harmed. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement.

For example, in our Annual Report on Form 10-K for the year ended December 31, 2004, our management reported that we did not maintain effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”), and identified two areas that constituted material weaknesses. The first material weakness related to deficiencies in our policies and procedures with respect to the reconciling of differences between the tax basis and book basis of each component of our deferred tax asset and liability accounts. The second material weakness related to deficiencies in our policies and procedures with respect to the accurate reporting of cash. The deficiencies included our failure to timely reconcile bank accounts and suspense accounts, as well as the improper application of GAAP related to the classification of outstanding checks. As a result of these material weaknesses, misstatements were discovered with respect to our deferred tax assets and liabilities and with respect to various expense accounts. These misstatements and deficiencies were first discovered and brought to the attention of management by KPMG LLP in connection with their 2004 audit of our consolidated financial statements. The misstatements, which were recorded in our December 31, 2004 consolidated financial statements, were immaterial and did not require the

restatement of any of our prior consolidated financial statements. However, we cannot provide assurance that any internal control weaknesses we may discover in the future will not require us to restate any of our prior consolidated financial statements.

During 2005, these two material weaknesses were fully remediated. Any failure to maintain the improvements made in our internal control over financial reporting could cause us to fail to produce accurate, reliable financial reports or to meet our reporting obligations and could cause the market to lose confidence in our reported financial information. As a result, our financial condition and results of operations could suffer materially.

***Interest rate fluctuations could negatively affect the income we derive from the difference between the interest rates we earn on our investments and the interest we pay under our annuity contracts.***

Significant changes in interest rates expose us to the risk of not earning income or experiencing losses based on the differences between the interest rates earned on our investments and the credited interest rates paid on our outstanding annuity contracts. Significant changes in interest rates may affect:

- the unrealized gains and losses in our investment portfolio and the related after-tax effect on our shareholders' equity and total capital;
- the book yield of our investment portfolio; and
- the ability of our insurance subsidiaries to maintain appropriate interest rate spreads over the fixed rates guaranteed in their life and annuity products.

Both rising and declining interest rates can negatively affect the income we derive from these interest rate spreads. During periods of falling interest rates, our investment earnings will be lower because new investments in fixed maturity securities will likely bear lower interest rates. We may not be able to fully offset the decline in investment earnings with lower crediting rates on our annuity contracts. During periods of rising interest rates, there may be competitive pressure to increase the crediting rates on our annuity contracts. We may not, however, have the ability immediately to acquire investments with interest rates sufficient to offset an increase in crediting rates under our annuity contracts. Although we develop and maintain asset/liability management programs and procedures designed to reduce the volatility of our income when interest rates are rising or falling, changes in interest rates can affect our interest rate spreads.

Changes in interest rates may also affect our business in other ways. For example, lower interest rates may result in decreased crediting rates on certain of our fixed-rate products which could make those products less attractive, leading to lower sales and/or increases in the level of life insurance and annuity product surrenders and withdrawals.

***The insurance industry is highly regulated.***

We are subject to extensive regulation and supervision in the jurisdictions in which we do business. Regulation generally is designed to protect the interests of policyholders, as opposed to stockholders and non-policyholder creditors. Such regulations, among other things, impose restrictions on the amount and type of investments our subsidiaries may hold. Certain states also regulate the rates insurers may charge for certain property and casualty products. Legislation and voter initiatives have expanded, in some instances, the states' regulation of rates and have increased data reporting requirements. Consumer-related pressures to roll back rates, even if not enacted by legislation or upheld upon judicial appeal, may affect our ability to obtain timely rate increases or operate at desired levels of profitability. Changes in insurance regulations, including

those affecting the ability of our insurance subsidiaries to distribute cash to us and those affecting the ability of our insurance subsidiaries to write profitable property and casualty insurance policies in one or more states, may adversely affect the financial condition and results of operations of our insurance subsidiaries.

Examples of governmental regulation that has adversely affected the operations of our insurance subsidiaries include:

- the adoption in several states of legislation and other regulatory action intended to reduce the premiums paid for automobile insurance by residents of those states;
- restrictions on a company's ability to achieve pricing adequacy and/or reduce their volume of business in catastrophe prone areas; and
- requirements that insurance companies:
  - pay assessments to support associations that fund state-sponsored insurance operations, or
  - involuntarily issue policies for high-risk automobile drivers.

Regulation that could adversely affect our insurance subsidiaries also includes statutory surplus and risk-based capital requirements. Maintaining appropriate levels of surplus, as measured by statutory accounting principles, is considered important by state insurance regulatory authorities and the private agencies that rate insurers' claims-paying abilities and financial strength. The failure of an insurance subsidiary to maintain levels of statutory surplus that are sufficient for the amount of its insurance written could result in increased regulatory scrutiny, action by state regulatory authorities or a downgrade by rating agencies.

Similarly, the NAIC has adopted a system of assessing minimum capital adequacy that is applicable to our insurance subsidiaries. This system, known as risk-based capital, is used to identify companies that may merit further regulatory action by analyzing the adequacy of the insurer's surplus in relation to statutory requirements.

Because state legislatures remain concerned about the availability and affordability of property and casualty insurance and the protection of policyholders, our insurance subsidiaries expect that they will continue to face efforts by those legislatures to expand regulations to cover these concerns. For example, in the Spring 2005 session, the Florida legislature implemented measures to address the effect of future and past multi-hurricane seasons. Any one of these measures, or similar future measures, could adversely affect the financial condition and results of operations of our insurance subsidiaries.

In the event of the insolvency, liquidation or other reorganization of any of our insurance subsidiaries, our creditors and stockholders would have no right to proceed against any such insurance subsidiary or to cause the liquidation or bankruptcy of any such insurance subsidiary under federal or state bankruptcy laws. The insurance laws of the domiciliary state would govern such proceedings and the relevant insurance commissioner would act as liquidator or rehabilitator for the insurance subsidiary. Creditors and policyholders of any such insurance subsidiary would be entitled to payment in full from the assets of the insurance subsidiary before we, as a stockholder, would be entitled to receive any distribution.

The financial position of our insurance subsidiaries also may be affected by court decisions that expand insurance coverage beyond the intention of the insurer at the time it originally issued an insurance policy.

***The insurance industry is highly cyclical.***

The results of companies in the insurance industry historically have been subject to significant fluctuations due to competition, economic conditions, interest rates and other factors. In particular, the property and casualty insurance segment of the industry historically have experienced pricing and profitability cycles. With respect to these cycles, the factors having the greatest impact include intense price competition, aggressive marketing by insurers and industry-wide underwriting results, which have resulted in higher combined loss and expense ratios.

***Litigation may harm our financial strength or reduce our profitability.***

Companies in the insurance industry have been subject to substantial litigation resulting from claims, disputes and other matters. Most recently, they have faced expensive claims, including class action lawsuits, alleging, among other things, improper sales practices and improper claims settlement procedures. Negotiated settlements of certain such actions have had a material adverse effect on many insurance companies. The resolution of such claims against any of our insurance subsidiaries, including the potential adverse effect on our reputation and charges against the earnings of our insurance subsidiaries as a result of legal defense costs, a settlement agreement or an adverse finding or findings against our insurance subsidiaries in such a claim, could materially adversely affect the financial condition and results of operations of our insurance subsidiaries.

**ITEM 1B. Unresolved Staff Comments**

None.

**ITEM 2. Properties**

HMEC's home office property at 1 Horace Mann Plaza in Springfield, Illinois, consists of an office building totaling approximately 214,000 square feet which is owned by the Company. The Company also owns buildings with an aggregate of approximately 24,000 square feet at other locations in Springfield. The Company leases buildings in Springfield with an aggregate of approximately 92,000 square feet. In addition, the Company leases office space in other states related to claims and agency offices which are smaller in size. These properties, which are utilized by all of the Company's operating segments, are adequate and suitable for the Company's current and anticipated future needs.

**ITEM 3. Legal Proceedings**

The Company is not currently party to any material pending legal proceedings other than routine litigation incidental to its business.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

None.

## PART II

### ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

HMEC's common stock began trading on the NYSE in November 1991 under the symbol of HMN at a price of \$9 per share. The following table sets forth the high and low sales prices of the common stock on the NYSE Composite Tape and the cash dividends paid per share of common stock during the periods indicated.

| <u>Fiscal Period</u> | <u>Market Price</u> |            | <u>Dividend Paid</u> |
|----------------------|---------------------|------------|----------------------|
|                      | <u>High</u>         | <u>Low</u> |                      |
| 2005:                |                     |            |                      |
| Fourth Quarter.....  | \$20.04             | \$17.96    | \$0.105              |
| Third Quarter.....   | 20.80               | 18.90      | 0.105                |
| Second Quarter.....  | 19.00               | 15.86      | 0.105                |
| First Quarter.....   | 19.20               | 17.31      | 0.105                |
| 2004:                |                     |            |                      |
| Fourth Quarter.....  | \$19.30             | \$16.01    | \$0.105              |
| Third Quarter.....   | 17.59               | 15.83      | 0.105                |
| Second Quarter.....  | 17.48               | 14.92      | 0.105                |
| First Quarter.....   | 16.10               | 13.94      | 0.105                |

As of February 28, 2006, the approximate number of holders of HMEC's common stock was 5,000.

In March 2006, the Company's Board of Directors announced a regular quarterly dividend of \$0.105 per share. The payment of dividends in the future is subject to the discretion of the Board of Directors and will depend upon general business conditions, legal restrictions and other factors the Board of Directors of HMEC may deem to be relevant. See also "Business -- Cash Flow".

During 2005, options were exercised for the issuance of 124,624 shares, 0.3% of the Company's common stock shares outstanding at December 31, 2004. The Company received \$2.1 million as a result of these option exercises, including related federal income tax benefits.

The equity compensation plan information required by Item 201(d) of Regulation S-K is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

### ITEM 6. Selected Financial Data

The information required by Item 301 of Regulation S-K is contained in the table in Item 1 -- "Business -- Selected Historical Consolidated Financial Data".

### ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The information required by Item 303 of Regulation S-K is listed on page F-1 of this report.

## **ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk**

The information required by Item 305 of Regulation S-K is contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" listed on page F-1 of this report.

## **ITEM 8. Consolidated Financial Statements and Supplementary Data**

The Company's consolidated financial statements, financial statement schedules, the report of its independent registered public accounting firm and the selected quarterly financial data required by Item 302 of Regulation S-K are listed on page F-1 of this report.

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

None.

## **ITEM 9A. Controls and Procedures**

### **a.) Management's Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) of the Securities and Exchange Act of 1934 as amended (the "Exchange Act"). Based on this evaluation, our chief executive officer and our chief financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2005, the end of the period covered by this Annual Report on Form 10-K.

### **b.) Management's Report on Internal Control Over Financial Reporting**

Management of Horace Mann is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is identified in Rule 13a-15(f) of the Exchange Act. 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 U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that:

- (i) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- (ii) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. 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
- (iii) 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.

Management of Horace Mann conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control -- Integrated Framework* ("COSO"). 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. Based on this evaluation, management determined that, as of December 31, 2005, the Company maintained effective internal control over financial reporting.

### **c.) Independent Registered Public Accounting Firm's Report on Internal Control Over Financial Reporting**

#### **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
Horace Mann Educators Corporation:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting (Item 9A.b.)* that Horace Mann Educators Corporation and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our 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 U.S. 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 U.S. 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 consolidated 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, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive income, change in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 15, 2006 expressed an unqualified opinion on those consolidated financial statements.

**KPMG LLP**

KPMG LLP

Chicago, Illinois  
March 15, 2006

#### **d). Changes in Internal Control Over Financial Reporting**

The following changes have been made subsequent to December 31, 2004 to remediate the material weaknesses described in the Company's 2004 Annual Report on Form 10-K and have materially affected the Company's internal control over financial reporting.

##### Income Tax Financial Reporting

The Company has fully remediated the material weakness in its internal control over income tax deferred assets and liabilities. Management has implemented the following remedial actions:

- Processes to compute and reconcile the book to tax basis differences at an asset and liability transaction level, including documentation and testing of enhanced processes and procedures have been implemented;
- A qualified tax officer was employed by the Company in March 2005 to allow for appropriate segregation of duties and to strengthen processes related to the preparation and review of tax asset and liability documentation and an additional tax accountant was employed by the Company in September 2005 to assist in the reconciliation process; and
- A tax consulting firm was engaged to review the Company's 2005 quarterly federal income tax provisions, along with related reconciliations and supporting documentation, for validity and consistency.

## Reporting of Cash Balances

The Company has fully remediated the material weakness in its internal control over the reporting of cash balances. Management has implemented the following remedial actions:

### Bank Account and Suspense Account Reconciliations

- Processes to reconcile and clear all suspense accounts on a timely basis, including a review of staffing levels and proficiencies, training, documentation and testing of enhanced processes and procedures have been implemented;
- Processes for the timely completion, review and testing of bank account reconciliations, including a review of staffing levels, proficiencies and training have been completed; and
- Remediation actions to address controller department staffing and training have been completed, including redeployment and retraining of existing staff, increased utilization of temporary employees and hiring of additional full-time employees.

### Accounting Policy for Outstanding Check Amounts

- Documentation of processes and procedures, along with appropriate training, to ensure that the Company's accounting policy, which has been corrected to conform with U.S. generally accepted accounting principles, is consistently applied on a going forward basis has been completed.

Other than the items noted above, there were no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **ITEM 9B. Other Information**

None.

## **PART III**

## **ITEM 10. Directors and Executive Officers of the Registrant**

The information required by Items 401 and 405 of Regulation S-K is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

Horace Mann Educators Corporation has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer and all other employees of the Company. In addition, the Board of Directors of Horace Mann Educators Corporation has adopted the code of ethics for its Board members as it applies to each Board members' business conduct on behalf of the Company. The code of ethics is posted on the Company's website, [www.horacemann.com](http://www.horacemann.com), under "Investor Relations -- Corporate Governance".

## **ITEM 11. Executive Compensation**

The information required by Item 402 of Regulation S-K is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

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

The information required by Items 201(d) and 403 of Regulation S-K is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

## **ITEM 13. Certain Relationships and Related Transactions**

The information required by Item 404 of Regulation S-K is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

## **ITEM 14. Principal Accounting Fees and Services**

The information required by Item 9(e) of Schedule 14A is incorporated by reference to the Company's Proxy Statement for the 2006 Annual Meeting of Shareholders.

## **PART IV**

## **ITEM 15. Exhibits and Financial Statement Schedules**

(a)(1) The following consolidated financial statements of the Company are contained in the Index to Financial Information on Page F-1 of this report:

Consolidated Balance Sheets as of December 31, 2005 and 2004.

Consolidated Statements of Operations and Comprehensive Income for the Years Ended December 31, 2005, 2004 and 2003.

Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2005, 2004 and 2003.

Consolidated Statements of Cash Flows for the Years Ended December 31, 2005, 2004 and 2003.

(a)(2) The following financial statement schedules of the Company are contained in the Index to Financial Information on page F-1 of this report:

Schedule I - Summary of Investments - Other than Investments in Related Parties.

Schedule II - Condensed Financial Information of Registrant.

Schedules III and VI Combined - Supplementary Insurance Information and Supplemental Information Concerning Property and Casualty Insurance Operations.

Schedule IV - Reinsurance.

(a)(3) The following items are filed as Exhibits. Management contracts and compensatory plans are indicated by an asterisk (\*).

**Exhibit  
No. \_\_\_\_\_**

**Description**

(3) Articles of incorporation and bylaws:

- 3.1 Restated Certificate of Incorporation of HMEC, filed with the Delaware Secretary of State on June 24, 2003, incorporated by reference to Exhibit 3.1 to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, filed with the Securities and Exchange Commission (the "SEC") on August 14, 2003.
- 3.2 Form of Certificate for shares of Common Stock, \$0.001 par value per share, of HMEC, incorporated by reference to Exhibit 4.5 to HMEC's Registration Statement on Form S-3 (Registration No. 33-53118) filed with the SEC on October 9, 1992.
- 3.3 Bylaws of HMEC, incorporated by reference to Exhibit 3.2 to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, filed with the SEC on August 14, 2003.

(4) Instruments defining the rights of security holders, including indentures:

- 4.1 Indenture, dated as of May 14, 2002, between HMEC and JPMorgan Chase Bank as trustee, with regard to HMEC's 1.425% Senior Convertible Notes Due 2032, incorporated by reference to Exhibit 4.1 to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, filed with the SEC on August 14, 2002.
- 4.1(a) Form of 1.425% Senior Convertible Notes Due 2032 (included in Exhibit 4.1).
- 4.2 Indenture, dated as of June 9, 2005, between HMEC and JPMorgan Chase Bank, N.A., as trustee, with regard to HMEC's 6.05% Senior Notes Due 2015, incorporated by reference to Exhibit 4.1 to HMEC's Current Report on Form 8-K dated June 6, 2005, filed with the SEC on June 9, 2005.
- 4.2(a) First Supplemental Indenture, dated as of June 9, 2005, between HMEC and JPMorgan Chase Bank, N.A., as trustee, incorporated by reference to Exhibit 4.2 to HMEC's Current Report on Form 8-K dated June 6, 2005, filed with the SEC on June 9, 2005.
- 4.2(b) Form of HMEC 6.05% Senior Notes Due 2015 (included in Exhibit 4.2(a)).
- 4.3 Certificate of Designations for HMEC Series A Cumulative Convertible Preferred Stock.

**Exhibit  
No.**

**Description**

(10) Material contracts:

- 10.1 Credit Agreement dated as of May 31, 2005 among HMEC, certain financial institutions named therein and Bank of America, N.A., as administrative agent (the "Agent"), incorporated by reference to Exhibit 10.1 to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, filed with the SEC on August 9, 2005.
- 10.1(a) First Amendment to Credit Agreement dated as of August 19, 2005 among HMEC, certain financial institutions named therein and the Agent, incorporated by reference to Exhibit 10.1(a) to HMEC's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, filed with the SEC on November 9, 2005.
- 10.2\* Horace Mann Educators Corporation Deferred Equity Compensation Plan for Directors, incorporated by reference to Exhibit 10.1 to HMEC's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996, filed with the SEC on November 14, 1996.
- 10.3\* Horace Mann Educators Corporation Deferred Compensation Plan for Employees, incorporated by reference to Exhibit 10.4 to HMEC's Annual Report on Form 10-K for the year ended December 31, 1997, filed with the SEC on March 30, 1998.
- 10.4\* Amended and Restated Horace Mann Educators Corporation 1991 Stock Incentive Plan, incorporated by reference to Exhibit 10.5 to HMEC's Annual Report on Form 10-K for the year ended December 31, 1999, filed with the SEC on March 30, 2000.
- 10.4(a)\* Amendment to Amended and Restated Horace Mann Educators Corporation 1991 Stock Incentive Plan, incorporated by reference to Exhibit 10.1(a) to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000, filed with the SEC on August 11, 2000.
- 10.4(b)\* Specimen Employee Stock Option Agreement under the Horace Mann Educators Corporation 1991 Stock Incentive Plan, incorporated by reference to Exhibit 10.5(a) to HMEC's Annual Report on Form 10-K for the year ended December 31, 1999, filed with the SEC on March 30, 2000.
- 10.4(c)\* Specimen Director Stock Option Agreement under the Horace Mann Educators Corporation 1991 Stock Incentive Plan, incorporated by reference to Exhibit 10.5(b) to HMEC's Annual Report on Form 10-K for the year ended December 31, 1999, filed with the SEC on March 30, 2000.
- 10.5\* Horace Mann Educators Corporation 2001 Stock Incentive Plan, incorporated by reference to Exhibit 10.6 to HMEC's Annual Report on Form 10-K for the year ended December 31, 2001, filed with the SEC on March 29, 2002.

**Exhibit  
No.**

**Description**

- 10.5(a)\* Specimen Employee Stock Option Agreement under the Horace Mann Educators Corporation 2001 Stock Incentive Plan, incorporated by reference to Exhibit 10.6(a) to HMEC's Annual Report on Form 10-K for the year ended December 31, 2001, filed with the SEC on March 29, 2002.
- 10.5(b)\* Specimen Director Stock Option Agreement under the Horace Mann Educators Corporation 2001 Stock Incentive Plan, incorporated by reference to Exhibit 10.6(b) to HMEC's Annual Report on Form 10-K for the year ended December 31, 2001, filed with the SEC on March 29, 2002.
- 10.6\* Horace Mann Educators Corporation Amended and Restated 2002 Incentive Compensation Plan ("2002 Incentive Compensation Plan"), incorporated by reference to Exhibit 10.2 to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, filed with the SEC on August 9, 2005.
- 10.6(a)\* Specimen Employee Stock Option Agreement under the 2002 Incentive Compensation Plan, incorporated by reference to Exhibit 10.2(a) to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, filed with the SEC on August 14, 2002.
- 10.6(b)\* Specimen Regular Employee Stock Option Agreement under the 2002 Incentive Compensation Plan, incorporated by reference to Exhibit 10.2(b) to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, filed with the SEC on August 14, 2002.
- 10.6(c)\* Specimen Director Stock Option Agreement under the 2002 Incentive Compensation Plan, incorporated by reference to Exhibit 10.2(c) to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, filed with the SEC on August 14, 2002.
- 10.6(d)\* Specimen Employee Restricted Stock Unit Agreement under the 2002 Incentive Compensation Plan.
- 10.6(e)\* Specimen Non-employee Director Restricted Stock Unit Agreement under the 2002 Incentive Compensation Plan.
- 10.6(f)\* Specimen Restricted Stock Unit Deferral Election Form under the 2002 Incentive Compensation Plan.
- 10.6(g)\* Specimen Modification to Stock Options outstanding as of June 30, 2004, incorporated by reference to Exhibit 10.2(d) to HMEC's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, filed with the SEC on August 9, 2004.
- 10.7\* Horace Mann Supplemental Employee Retirement Plan, 2002 Restatement, incorporated by reference to Exhibit 10.1 to HMEC's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, filed with the SEC on May 15, 2002.

**Exhibit  
No.**

**Description**

- 10.8\* Horace Mann Executive Supplemental Employee Retirement Plan, 2002 Restatement, incorporated by reference to Exhibit 10.2 to HMEC's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, filed with the SEC on May 15, 2002.
- 10.9\* Horace Mann Nonqualified Supplemental Money Purchase Pension Plan, incorporated by reference to Exhibit 10.3 to HMEC's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2002, filed with the SEC on May 15, 2002.
- 10.10\* Summary of HMEC Non-Employee Director Compensation.
- 10.11\* Summary of HMEC Named Executive Officer Annualized Salary.
- 10.12\* Severance Agreements between HMEC and certain officers of HMEC, incorporated by reference to Exhibit 10.7 to HMEC's Annual Report on Form 10-K for the year ended December 31, 2001, filed with the SEC on March 29, 2002.
- 10.12(a)\* Revised Schedule to Severance Agreements between HMEC and certain officers of HMEC, incorporated by reference to Exhibit 10.2(a) to HMEC's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, filed with the SEC on November 9, 2005.
- 10.13\* Change in Control Agreement between HMEC, Horace Mann Service Corporation ("HMSC") and certain officers of HMEC and/or HMSC, incorporated by reference to Exhibit 10.13 to HMEC's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the SEC on March 31, 2005.
- 10.13(a)\* Schedule to Change in Control Agreements between HMEC, HMSC and certain officers of HMEC and/or HMSC, incorporated by reference to Exhibit 10.13(a) to HMEC's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the SEC on March 31, 2005.
- 10.14\* Employment Agreement between HMEC and Louis G. Lower II as of December 31, 1999, incorporated by reference to Exhibit 10.12 to HMEC's Annual Report on Form 10-K for the year ended December 31, 1999, filed with the SEC on March 30, 2000.
- 10.15\* Letter of Employment between HMSC and Frank D'Ambra III effective February 1, 2005, incorporated by reference to Exhibit 10.15 to HMEC's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the SEC on March 31, 2005.
- (11) Statement regarding computation of per share earnings.
- (12) Statement regarding computation of ratios.
- (21) Subsidiaries of HMEC.

**Exhibit  
No.**

**Description**

- (23) Consent of KPMG LLP.
- (31) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.1 Certification by Louis G. Lower II, Chief Executive Officer of HMEC.
  - 31.2 Certification by Peter H. Heckman, Chief Financial Officer of HMEC.
- (32) Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certification by Louis G. Lower II, Chief Executive Officer of HMEC.
  - 32.2 Certification by Peter H. Heckman, Chief Financial Officer of HMEC.
- (99) Additional exhibits
  - 99.1 Glossary of Selected Terms.
  - (b) See list of exhibits in this Item 15.
  - (c) See list of financial statement schedules in this Item 15.

Copies of Exhibits, Horace Mann Educators Corporation's Code of Ethics and charters of the committees of the Board of Directors may be obtained by writing to Investor Relations, Horace Mann Educators Corporation, 1 Horace Mann Plaza, C-120, Springfield, Illinois 62715-0001.

## SIGNATURES

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

HORACE MANN EDUCATORS CORPORATION

/s/ Louis G. Lower II

Louis G. Lower II  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Horace Mann Educators Corporation and in the capacities and on the date indicated.

Principal Executive Officer:

/s/ Louis G. Lower II

Louis G. Lower II  
President,  
Chief Executive Officer and a Director

Directors:

/s/ Joseph J. Melone

Joseph J. Melone, Chairman of the  
Board of Directors

/s/ William W. Abbott

William W. Abbott, Director

Principal Financial Officer:

/s/ Peter H. Heckman

Peter H. Heckman  
Executive Vice President and  
Chief Financial Officer

/s/ Mary H. Futrell

Mary H. Futrell, Director

/s/ Stephen J. Hasenmiller

Stephen J. Hasenmiller, Director

\_\_\_\_\_  
Jeffrey L. Morby, Director

Principal Accounting Officer:

/s/ Bret A. Conklin

Bret A. Conklin  
Senior Vice President and Controller

/s/ Shaun F. O'Malley

Shaun F. O'Malley, Director

/s/ Charles A. Parker

Charles A. Parker, Director

Dated: March 15, 2006

# HORACE MANN EDUCATORS CORPORATION

## INDEX TO FINANCIAL INFORMATION

|   | <u>Page</u> |
|---|-------------|
| Management's Discussion and Analysis of<br>Financial Condition and Results of Operations .....  | F- 2        |
| Report of Management Responsibility for Financial Statements .....  | F-34        |
| Report of Independent Registered Public Accounting Firm .....   | F-35        |
| Consolidated Balance Sheets .....   | F-36        |
| Consolidated Statements of Operations and Comprehensive Income .....  | F-37        |
| Consolidated Statements of Changes in Shareholders' Equity .....  | F-38        |
| Consolidated Statements of Cash Flows.....  | F-39        |
| Notes to Consolidated Financial Statements  |             |
| Note 1 - Summary of Significant Accounting Policies.....  | F-40        |
| Note 2 - Investments .....  | F-50        |
| Note 3 - Property and Casualty Unpaid Claims and Claim Expenses .....   | F-54        |
| Note 4 - Debt.....  | F-57        |
| Note 5 - Shareholders' Equity and Stock Options .....   | F-60        |
| Note 6 - Income Taxes .....   | F-63        |
| Note 7 - Fair Value of Financial Instruments .....  | F-65        |
| Note 8 - Statutory Surplus and Subsidiary Dividend Restrictions .....   | F-67        |
| Note 9 - Pension Plans and Other Postretirement Benefits.....   | F-69        |
| Note 10 - Catastrophes and Reinsurance .....  | F-75        |
| Note 11 - Contingencies and Commitments.....  | F-77        |
| Note 12 - Supplementary Data on Cash Flows .....  | F-78        |
| Note 13 - Segment Information .....   | F-79        |
| Note 14 - Unaudited Selected Quarterly Financial Data.....  | F-81        |
| Financial Statement Schedules:  |             |
| Schedule I - Summary of Investments-Other than Investments in<br>Related Parties.....   | F-82        |
| Schedule II - Condensed Financial Information of Registrant .....   | F-83        |
| Schedule III and VI Combined - Supplementary Insurance Information<br>and Supplemental Information Concerning Property and Casualty<br>Insurance Operations ..... | F-87        |
| Schedule IV - Reinsurance.....  | F-88        |

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

### Forward-looking Information

Statements made in the following discussion that state the Company's or management's intentions, hopes, beliefs, expectations or predictions of future events or the Company's future financial performance are forward-looking statements and involve known and unknown risks, uncertainties and other factors. Horace Mann is not under any obligation to (and expressly disclaims any such obligation to) update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. It is important to note that the Company's actual results could differ materially from those projected in forward-looking statements due to, among other risks and uncertainties inherent in the Company's business, the following important factors:

- Changes in the composition of the Company's assets and liabilities which may result from occurrences such as acquisitions, divestitures, impairment in asset values or changes in estimates of insurance reserves.
- Fluctuations in the market value of securities in the Company's investment portfolio and the related after-tax effect on the Company's shareholders' equity and total capital through either realized or unrealized investment losses. In addition, the impact of fluctuations in the financial markets on the Company's defined benefit pension plan assets and the related after-tax effect on the Company's operating expenses, shareholders' equity and total capital.
- The impact of fluctuations in the financial markets on the Company's variable annuity fee revenues, valuations of deferred policy acquisition costs and value of acquired insurance in force, and the level of guaranteed minimum death benefit reserves.
- The impact of fluctuations in the capital markets on the Company's ability to refinance outstanding indebtedness or repurchase shares of the Company's common stock.
- Defaults on interest or dividend payments in the Company's investment portfolio due to credit issues and the resulting impact on investment income.
- Prevailing interest rate levels, including the impact of interest rates on (i) unrealized gains and losses in the Company's investment portfolio and the related after-tax effect on the Company's shareholders' equity and total capital, (ii) the book yield of the Company's investment portfolio and (iii) the Company's ability to maintain appropriate interest rate spreads over the fixed rates guaranteed in the Company's life and annuity products.
- The cyclical nature of the insurance industry and the related effects of changes in price competition and industry-wide underwriting results.
- The frequency and severity of catastrophes such as hurricanes, earthquakes, storms and wildfires and the ability of the Company to provide accurate estimates of ultimate catastrophe costs in its consolidated financial statements in light of such factors as: the proximity of the catastrophe occurrence date to the date of the consolidated financial statements; potential inflation of property repair costs in the affected area; the occurrence of multiple catastrophes in a geographic area over a relatively short period of time; the outcome of litigation which may be filed against the Company by policyholders, state attorneys general and other parties relative to loss coverage disputes and loss settlement payments; and the ability of state insurance facilities to assess participating insurers when financial deficits occur.

- Based on property and casualty direct earned premiums for 2005, the Company's ten largest states represented 56% of the segment total. Included in this top ten group are certain states in which catastrophe occurrences are relatively common: California, Florida, North Carolina, South Carolina, Louisiana and Texas.
- Underwriting actions to mitigate the Company's risk exposure to catastrophe-prone areas could have a near-term negative impact on premium, policy and earnings growth.
- The ability of the Company to maintain a favorable catastrophe reinsurance program considering both availability and cost; and the collectibility of reinsurance receivables.
- Adverse development of property and casualty loss and loss adjustment expense reserve experience and its impact on estimated claims and claim settlement expenses for losses occurring in prior years.
- Adverse changes in business persistency, policyholder mortality and morbidity rates and the resulting impact on both estimated reserves and the valuations of deferred policy acquisition costs and value of acquired insurance in force.
- Changes in insurance regulations, including (i) those affecting the ability of the Company's insurance subsidiaries to distribute cash to the holding company and (ii) those impacting the Company's ability to profitably write property and casualty insurance policies in one or more states.
- Changes in accounting or financial reporting standards issued by the FASB, SEC or other standard-setting bodies which may have an adverse effect on the Company's financial condition, results of operations and/or cost of doing business.
- Changes in federal income tax laws and changes resulting from federal tax audits affecting corporate tax rates or taxable income.
- Changes in federal and state laws and regulations which affect the relative tax and other advantages of the Company's life and annuity products to customers, including, but not limited to, changes in IRS regulations governing 403(b) plans.
- The resolution of legal proceedings and related matters including the potential adverse impact on the Company's reputation and charges against the Company's earnings resulting from legal defense costs, a settlement agreement and/or an adverse finding or findings against the Company from the proceedings.
- The Company's ability to maintain favorable claims-paying ability, financial strength and debt ratings.
- The competitive impact of entrants such as mutual funds and banks into the tax-deferred annuity products markets, and the Company's ability to profitably expand its property and casualty business in highly competitive environments.
- The Company's ability to develop and expand its agent force and its independent agent distribution system, as well as the Company's ability to maintain and secure product sponsorships by local, state and national education associations.
- The risk related to the Company's dated and complex information systems, which are more prone to error than advanced technology systems.
- Disruptions of the general business climate, investments, capital markets and consumer attitudes caused by pandemics or geopolitical acts such as terrorism, war or other similar events.
- The impact of a disaster or catastrophic event affecting the Company's employees or its home office facilities and the Company's ability to recover and resume its business operations on a timely basis.

## Executive Summary

Horace Mann Educators Corporation ("HMEC"; and together with its subsidiaries, the "Company" or "Horace Mann") is an insurance holding company. Through its subsidiaries, HMEC markets and underwrites personal lines of property and casualty and life insurance and retirement annuities in the U.S. The Company markets its products primarily to educators and other employees of public schools and their families.

For 2005, the Company's net income increased compared to the prior year, primarily reflecting improved property and casualty segment earnings. This improvement was driven by tightened underwriting standards and pricing actions taken in recent years, ongoing improvements in claims processes, cost containment initiatives, and generally low non-catastrophe claim frequencies. For the Company, and for the property and casualty insurance industry, catastrophe costs were significant in both 2005 and 2004. However, the Company's catastrophe costs for 2005 were lower than those for 2004. Net income in 2005 also benefited from favorable development of prior years' claim reserves.

Horace Mann received refunds from the Internal Revenue Service ("IRS") in April 2005, including amounts related to tax years 1996 and 1997, which were deemed to be closed. In September 2005, tax years 1998 through 2001 were also deemed closed. This resulted in the elimination of the contingent tax liability related to those six years, which reduced federal income tax expense for 2005 by \$9.1 million (\$2.7 million and \$6.4 million in the second and third quarters, respectively). In addition, \$1.4 million of interest on the tax refund amounts was received and recorded as pretax income in the second quarter.

Premiums written and contract deposits decreased 3% compared to 2004. Property and casualty premiums written declined as increases in average voluntary automobile and homeowners premium per policy -- which were moderated to some extent by the improvement in the quality of the books of business -- were more than offset by the decline in policies in force in these lines. Also, property and casualty catastrophe reinsurance reinstatement premiums were higher in 2005, representing one-half percentage point of the decline. In addition to the decline in property and casualty premiums written, new annuity single premium and rollover deposit receipts declined compared to 2004.

During 2003 and 2004, the Company improved the underlying operating results of its property and casualty segment and substantially increased the new sales volume and retention of business in its annuity segment. However, that underlying operating progress was substantially offset by other factors which suppressed the Company's net income. In 2004, the Company experienced a record level of catastrophe costs. In 2003, the Company recorded adverse development of prior years' property and casualty reserves, primarily related to voluntary automobile liability claims. In addition, in both years the Company experienced spread compression in its fixed annuity business, as a result of credit-related investment losses in 2003 and declining investment yields.

## Critical Accounting Policies

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires the Company's management to make estimates and assumptions based on information available at the time the consolidated financial statements are prepared. These estimates and assumptions affect the reported amounts of the Company's consolidated assets, liabilities, shareholders' equity and net income. Certain accounting estimates are particularly sensitive because of their significance to the Company's consolidated financial statements and because of the possibility that subsequent events and available information may differ markedly from management's judgements at the time the consolidated financial statements were prepared. Management has discussed with the Audit Committee the quality, not just the acceptability, of the Company's accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the Company's accounting policies and their application, and the clarity and completeness of the Company's consolidated financial statements, which include related disclosures. For the Company, the areas most subject to significant management judgements include: liabilities for property and casualty claims and claim settlement expenses, liabilities for future policy benefits, deferred policy acquisition costs, value of acquired insurance in force for annuity and interest-sensitive life products, valuation of investments and valuation of assets and liabilities related to the defined benefit pension plan.

### *Liabilities for Property and Casualty Claims and Claim Settlement Expenses*

Underwriting results of the property and casualty segment are significantly influenced by estimates of the Company's ultimate liability for insured events. There is a high degree of uncertainty inherent in the estimates of ultimate losses underlying the liability for unpaid claims and claim settlement expenses. This inherent uncertainty is particularly significant for liability-related exposures due to the extended period, often many years, that transpires between a loss event, receipt of related claims data from policyholders and ultimate settlement of the claim. Reserves for property and casualty claims include provisions for payments to be made on reported claims, claims incurred but not yet reported ("IBNR") and associated settlement expenses. The process by which these reserves are established requires reliance upon estimates based on known facts and on interpretations of circumstances, including the Company's experience with similar cases and historical trends involving claim payments and related patterns, pending levels of unpaid claims and product mix, as well as other factors including court decisions, economic conditions and public attitudes.

The Company continually updates loss estimates using both quantitative and qualitative information from its reserving actuaries and information derived from other sources. Adjustments may be required as information develops which varies from experience, or, in some cases, augments data which previously were not considered sufficient for use in determining liabilities. The effects of these adjustments may be significant and are charged or credited to income for the period in which the adjustments are made. Detailed discussion of the impact of adjustments recorded during recent years is included in "Results of Operations for the Three Years Ended December 31, 2005 -- Benefits, Claims and Settlement Expenses" and in the "Notes to Consolidated Financial Statements -- Note 3 -- Property and Casualty Unpaid Claims and Claim Expenses" listed on page F-1 of this report. Due to the nature of the Company's personal lines business, the Company has no exposure to claims for toxic waste cleanup, other environmental remediation or asbestos-related illnesses other than claims under homeowners insurance policies for environmentally related items such as mold.

The Company completes a detailed study of property and casualty reserves based on information available at the end of each quarter and year. Trends of reported losses (paid amounts and case reserves on claims reported to the Company) for each accident year are reviewed and ultimate loss costs for those accident years are estimated. For 2001 through 2005, the Company engaged an independent property and casualty actuarial consulting firm to prepare an independent study of the Company's property and casualty reserves at June 30 and December 31 of each year. Beginning in 2006, the independent actuarial consulting firm will prepare an independent study of reserves at December 31, supplemented by other analyses throughout the year.

The Company's liabilities for property and casualty unpaid claims and claim settlement expenses were as follows:

|                           | December 31, 2005 |                |                | December 31, 2004 |                |                |
|---------------------------|-------------------|----------------|----------------|-------------------|----------------|----------------|
|                           | Case Reserves     | IBNR Reserves  | Total (1)      | Case Reserves     | IBNR Reserves  | Total (1)      |
| Automobile liability..... | \$ 77.3           | \$144.3        | \$221.6        | \$ 88.8           | \$138.4        | \$227.2        |
| Automobile other .....    | 13.9              | 5.7            | 19.6           | 13.7              | 2.7            | 16.4           |
| Homeowners .....          | 14.4              | 52.0           | 66.4           | 17.0              | 44.0           | 61.0           |
| All other .....           | 7.6               | 27.5           | 35.1           | 5.0               | 25.4           | 30.4           |
| Total.....                | <u>\$113.2</u>    | <u>\$229.5</u> | <u>\$342.7</u> | <u>\$124.5</u>    | <u>\$210.5</u> | <u>\$335.0</u> |

(1) These amounts are gross, before reduction for ceded reinsurance reserves.

Some risk factors will affect more than one product line. One of these factors is changes in claim department practices, including claim closure rates, number of claims closed without payment, the use of outside claims adjusters, and the level of needed case reserve estimated by the adjuster. Other risk factors include changes in claim frequency, changes in claim severity, regulatory and legislative actions, court actions, changes in economic conditions and trends (medical costs, labor rates, the cost of materials), the occurrence of unusually large or frequent catastrophic loss events, timeliness of claim reporting, the state in which the claim occurred, and degree of claimant fraud. The extent of the impact of a risk factor will also vary by coverages within a product line. Individual risk factors are also subject to interactions with other risk factors within product line coverages.

While all product lines are exposed to these risks, there are some loss types or product lines for which the financial affect will be more significant. For instance, the use of outside adjusters for large catastrophe losses adds a level of risk to this loss type not present when employee adjusters handle claims. Also, given the relatively large proportion (approximately 60%) of the Company's reserves that are in the longer-tail auto liability coverages, regulatory and court actions and changes in economic conditions and trends could be expected to impact this product line more extensively than others.

As noted above, there are a number of assumptions involved in the determination of the Property and Casualty liability for unpaid claims and claim settlement expense ("loss reserves"). Amongst the factors affecting recorded loss reserves, claim severity is of particular significance. Management believes that claim severity is reasonably likely to deviate by 1% from the targeted claim severity for the most recent 36-month period. This deviation would have between a \$3 million and \$5 million impact on net loss reserves on auto liability coverages and between a \$1.5 million to \$2.0 million impact on net loss reserves on homeowners coverages. These results may change, depending on the magnitude and direction of the deviation.

Information regarding the Company's property and casualty segment claims and claims settlement expense reserve development is located in "Business -- Property and Casualty Segment -- Property and Casualty Reserves".

#### *Liabilities for Future Policy Benefits*

Liabilities for future benefits on life and annuity policies are established in amounts adequate to meet the estimated future obligations on policies in force. Liabilities for future policy benefits on certain life insurance policies are computed using the net level premium method and are based on assumptions as to future investment yield, mortality and withdrawals. Mortality and withdrawal assumptions for all policies have been based on actuarial tables which are consistent with the Company's own experience. Liabilities for future benefits on annuity contracts and certain long-duration life insurance contracts are carried at accumulated policyholder values without reduction for potential surrender or withdrawal charges. In the event actual experience varies from the estimated liability assumptions, adjustments are charged or credited to income for the period in which the adjustments are made.

#### *Deferred Policy Acquisition Costs and Value of Acquired Insurance in Force for Annuity and Interest-Sensitive Life Products*

Policy acquisition costs, consisting of commissions, policy issuance and other costs, which vary with and are primarily related to the production of business, are capitalized and amortized on a basis consistent with the type of insurance coverage. For all investment (annuity) contracts, acquisition costs, and also the value of annuity business acquired in the 1989 acquisition of the Company ("Annuity VIF"), are amortized over 20 years in proportion to estimated gross profits. Capitalized acquisition costs for interest-sensitive life contracts are also amortized over 20 years in proportion to estimated gross profits.

The most significant assumptions that are involved in the estimation of annuity gross profits include future financial market performance, interest rate spreads, business surrender/lapse rates and the impact of realized investment gains and losses. For the variable deposit portion of the annuity segment, the Company amortizes policy acquisition costs and the Annuity VIF utilizing a future financial market performance assumption of a 10% reversion to the mean approach with a 200 basis point corridor around the mean. At December 31, 2005, the ratio of capitalized annuity policy acquisition costs and the Annuity VIF asset to the total annuity accumulated cash value was approximately 4%.

In the event actual experience differs significantly from assumptions or assumptions are significantly revised, the Company may be required to record a material charge or credit to amortization expense for the period in which the adjustment is made. As noted above, there are a number of assumptions involved in the valuation of capitalized policy acquisition costs and the Annuity VIF. As one example of the volatility of this amortization, if all other assumptions are met, a 1% deviation from the targeted financial market performance for the underlying mutual funds of the Company's variable annuities would currently impact amortization between \$0.1 million and \$0.2 million. This result may change depending on the magnitude and direction of the deviation. Detailed discussion of the impact of adjustments to the amortization of capitalized acquisition costs and Annuity VIF is included in "Results of Operations for the Three Years Ended December 31, 2005 -- Amortization of Policy Acquisition Expenses and Intangible Assets".

## *Valuation of Investments*

The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Based on these facts, if management believes it is probable that amounts due will not be collected according to the contractual terms of a debt security not impaired at acquisition, or if the Company does not have the ability or intent to hold a security with an unrealized loss until it matures or recovers in value, an other-than-temporary impairment shall be considered to have occurred. As a general rule, if the fair value of a debt security has fallen below 80% of book value for more than six months, this security will be reviewed for an other-than-temporary impairment. Additionally, if events become known that call into question whether the security issuer has the ability to honor its contractual commitments, whether or not such security has been trading above an 80% fair value to book value relationship, such security holding will be evaluated to determine whether or not such security has suffered an other-than-temporary decline in value.

The Company reviews the fair value of all investments in its portfolio on a monthly basis to assess whether an other-than-temporary decline in value has occurred. These reviews, in conjunction with the Company's investment managers' monthly credit reports and relevant factors such as (1) the financial condition and near-term prospects of the issuer, (2) the Company's ability or intent to retain the investment long enough to allow for the anticipated recovery in fair value, (3) the stock price trend of the issuer, (4) the market leadership position of the issuer, (5) the debt ratings of the issuer and (6) the cash flows of the issuer, are all considered in the impairment assessment. A write-down of an investment is recorded when a decline in the fair value of that investment is deemed to be other-than-temporary, with a realized investment loss charged to income for the period.

A decline in fair value below amortized cost is not assumed to be other-than-temporary for fixed maturity investments with unrealized losses due to market conditions or industry-related events where there exists a reasonable expectation that fair value will recover versus historical cost and the Company has the intent and ability to hold the investment until maturity or a market recovery is realized. An other-than-temporary impairment loss will be recognized based upon all relevant facts and circumstances for each investment, as appropriate.

## *Valuation of Assets and Liabilities Related to the Defined Benefit Pension Plan*

Effective April 1, 2002, participants stopped accruing benefits under the defined benefit pension plan but continue to retain the benefits they had accrued to date.

The Company's cost estimates for its defined benefit pension plan are determined annually based on assumptions which include the discount rate, expected return on plan assets, anticipated retirement rate and estimated lump sum distributions. A discount rate of 5.5% was used by the Company for estimating accumulated benefits under the plan at December 31, 2005, which was based on the average yield for long-term, high grade securities having maturities generally consistent with the defined benefit pension payout period. To set its discount rate, the Company looks to leading indicators, including Moody's Aa long-term bond index. The expected annual return on plan assets assumed by the Company at December 31, 2005 was 7.5%. The assumption for the long-term rate of return on plan assets was determined by considering actual investment experience during the lifetime of the plan, balanced with reasonable expectations of future growth considering the various classes of assets and percentage allocation for each asset class. Management believes that it has adopted realistic assumptions for investment returns, discount rates and other key factors used in the estimation of pension costs and asset values.

To the extent that actual experience differs from the Company's assumptions, subsequent adjustments may be required, with the effects of those adjustments charged or credited to income and/or shareholders' equity for the period in which the adjustments are made. Generally, a change of 50 basis points in the discount rate would inversely impact pension expense and accumulated other comprehensive income ("AOCI") by approximately \$0.2 million and \$2 million, respectively. In addition, for every \$1 million increase in the value of pension plan assets, there is an equal increase in AOCI.

## Results of Operations for the Three Years Ended December 31, 2005

### Insurance Premiums and Contract Charges

#### Insurance Premiums Written and Contract Deposits

|                                       | Year Ended<br>December 31, |                | Growth Over<br>Prior Year |                 | Year Ended           |
|---------------------------------------|----------------------------|----------------|---------------------------|-----------------|----------------------|
|                                       | 2005                       | 2004           | Percent                   | Amount          | December 31,<br>2003 |
| Property & casualty                   |                            |                |                           |                 |                      |
| Automobile and property               |                            |                |                           |                 |                      |
| (voluntary) (1).....                  | \$535.2                    | \$552.5        | -3.1%                     | \$(17.3)        | \$549.2              |
| Involuntary and other                 |                            |                |                           |                 |                      |
| property & casualty .....             | 11.7                       | 9.8            |                           | 1.9             | (2.7)                |
| Total property & casualty (1) .....   | 546.9                      | 562.3          | -2.7%                     | (15.4)          | 546.5                |
| Annuity deposits .....                | 320.1                      | 327.0          | -2.1%                     | (6.9)           | 296.6                |
| Life .....                            | 105.6                      | 109.1          | -3.2%                     | (3.5)           | 112.4                |
| Total (1) .....                       | <u>\$972.6</u>             | <u>\$998.4</u> | -2.6%                     | <u>\$(25.8)</u> | <u>\$955.5</u>       |
| Effect of property and casualty       |                            |                |                           |                 |                      |
| catastrophe reinsurance reinstatement |                            |                |                           |                 |                      |
| premiums, included above.....         | \$ (9.9)                   | \$ (5.0)       |                           | \$ (4.9)        | \$ -                 |

(1) The amount for the year ended December 31, 2004 was reduced by \$4.0 million of previously escrowed premiums returned to North Carolina automobile policyholders. See further discussion of this topic below.

#### Insurance Premiums and Contract Charges Earned

(Excludes annuity and life contract deposits)

|   | Year Ended<br>December 31, |                | Growth Over<br>Prior Year |                | Year Ended           |
|---|----------------------------|----------------|---------------------------|----------------|----------------------|
|   | 2005                       | 2004           | Percent                   | Amount         | December 31,<br>2003 |
| Property & casualty                         |                            |                |                           |                |                      |
| Automobile and property                     |                            |                |                           |                |                      |
| (voluntary) .....                           | \$538.8                    | \$552.0        | -2.4%                     | \$(13.2)       | \$534.8              |
| Involuntary and other                       |                            |                |                           |                |                      |
| property & casualty .....                   | 10.8                       | 9.3            |                           | 1.5            | (1.0)                |
| Total property & casualty .....             | 549.6                      | 561.3          | -2.1%                     | (11.7)         | 533.8                |
| Annuity .....                               | 17.9                       | 16.7           | 7.2%                      | 1.2            | 14.6                 |
| Life .....                                  | 97.4                       | 96.7           | 0.7%                      | 0.7            | 95.1                 |
| Total .....                                 | <u>\$664.9</u>             | <u>\$674.7</u> | -1.5%                     | <u>\$(9.8)</u> | <u>\$643.5</u>       |
| Effect of property and casualty catastrophe |                            |                |                           |                |                      |
| reinsurance reinstatement premiums,         |                            |                |                           |                |                      |
| included above .....                        | \$ (9.9)                   | \$ (5.0)       |                           | \$ (4.9)       | \$ -                 |

For 2005, the Company's premiums written and contract deposits decreased 2.6% compared to 2004. Property and casualty premiums written declined as increases in average voluntary automobile and homeowners premium per policy -- which were moderated to some extent by the improvement in the quality of the books of business -- were more than offset by the decline in policies in force in these lines. Also, property and casualty catastrophe reinsurance reinstatement premiums were higher in 2005 representing 0.5 percentage point of the decline. In

addition to the decline in property and casualty premiums written, new annuity single premium and rollover deposit receipts declined compared to 2004. For 2004, the Company's premiums written and contract deposits increased 4.5% compared to 2003 as a result of growth in new annuity deposits and rate increases in the voluntary property and automobile lines. The 4.5% growth rate is net of (1) the impact of \$5.0 million of property and casualty catastrophe reinsurance reinstatement premiums incurred in 2004 which reduced the growth rate by 0.5 percentage point and (2) the impact of \$4.0 million of previously escrowed premiums returned to North Carolina automobile policyholders in 2004 which reduced the growth rate by 0.4 percentage point. Voluntary property and casualty business represents policies sold through the Company's marketing organization and issued under the Company's underwriting guidelines. Involuntary property and casualty business consists of allocations of business from state mandatory insurance facilities and assigned risk business.

The Company's exclusive agent force totaled 855 at December 31, 2005, reflecting an increase of 6.9% compared to 800 agents at December 31, 2004. At December 31, 2003, the Company had 888 agents. Management currently anticipates additional growth in the size of the Company's exclusive agent force in 2006, although at a more modest rate than in 2005 as the Company implements increased selectivity in agent geographic placement and further tightens underwriting standards in hurricane-prone coastal areas. During 2005, additional emphasis was placed on further improvements in agent retention, as well as on hiring an increased number of quality candidates. Of the 2005 total, 255 agents were in their first 24 months with the Company, reflecting a decrease of 2.3% compared to December 31, 2004, largely due to the reduced number of new hires in 2004 and retention levels in the last three months of 2004. A greater number of new agents were hired in 2005 compared to 2004. Terminations of agents in their first 24 months with the Company were approximately one-half of the level experienced in 2004. The number of experienced agents in the agent force, 600, increased 11.3% compared to a year earlier as a result of improved retention. Following an increase of 21% in 2004, average agent productivity decreased modestly in 2005 compared to full year 2004 in total and for all product lines. However, fourth quarter 2005 automobile and property average agent productivity, measured in sales units, improved compared to the same period in the prior year. Average agent productivity is measured as new sales premiums from the exclusive agent force per the average number of exclusive agents for the period.

For full year 2005, total sales, which include the independent agent distribution channel, decreased 3.2% compared to 2004, largely due to a decrease in new annuity business. Compared to a record level of annuity sales in 2004, total new annuity sales decreased 3.7% in 2005. This decline was primarily attributable to the career agent force. The decline also included a lower level of annuity new business from independent agents, with the rate of decline narrowing in the third and fourth quarters following a transition period to implement the Company's desired shift in mix of business from this channel. The improved automobile and property sales in the fourth quarter of 2005 -- driven by gains in average agent productivity for these products -- pushed these two lines to full year growth over 2004.

Total voluntary automobile and homeowners premium written decreased 3.1% in 2005 with approximately 1 percentage point of the decline attributable to the higher level of catastrophe reinsurance reinstatement premiums in 2005. While the quality of the Company's voluntary automobile and homeowners business continues to improve, the premium impact of increases in average premium per policy for both lines were more than offset by the decline in policies in force. Total voluntary automobile and homeowners premium written increased 0.6% in 2004 net of (1) the impact of the \$5.0 million catastrophe reinsurance reinstatement premium, which reduced this growth rate by approximately 1 percentage point, and (2) the impact of the \$4.0 million return of

escrowed premiums to North Carolina automobile policyholders, which reduced this growth rate by 0.7 percentage point. Voluntary automobile insurance premium written decreased 4.3% (\$17.1 million) compared to 2004, while homeowners premium decreased 0.1% (\$0.2 million) including a decrease of \$4.9 million due to the higher level of catastrophe reinsurance reinstatement premiums in 2005. Voluntary automobile insurance premium written decreased 0.3% (\$1.2 million) compared to 2003, and homeowners premium increased 3.0% (\$4.5 million). Average written premium was flat in 2005 and increased approximately 4% in 2004 for voluntary automobile and increased approximately 5% in 2005 and 11% in 2004 for homeowners compared to the respective prior years. Average earned premium increased 1% in 2005 and 5% in 2004 for voluntary automobile and 9% and 11% for homeowners in 2005 and 2004, respectively. In 2005, approved rate increases for the Company's automobile and homeowners business were minimal compared to approved increases of 7% and 15%, respectively, during 2004. During 2005, automobile policies in force decreased by 14,000 compared to December 31, 2004. Voluntary automobile policies in force at December 31, 2004 decreased by 26,000 compared to a year earlier. The Company continues to increase educator business as a percentage of both new and total voluntary automobile policies. Homeowners policies in force decreased 7,000 during 2005 and 6,000 during 2004, reflecting expected reductions primarily in non-educator policies due to the Company's pricing and underwriting actions. At December 31, 2005, there were 531,000 voluntary automobile and 266,000 homeowners policies in force, for a total of 797,000 policies, compared to a total of 818,000 policies at December 31, 2004 and 850,000 at December 31, 2003. To curtail the decline in automobile policies in force, in 2005 the Company implemented both short- and medium-term initiatives to increase new business and improve policy retention.

Based on policies in force, the total property and casualty 12-month retention rate for new and renewal policies was 85% in 2005, 84% in 2004 and 85% in 2003.

Due to rate limitations for coastal homeowners policies in Florida and to further reduce exposure to catastrophic losses, the Company has undertaken a reunderwriting program which resulted in non-renewal of approximately 3,300 homeowners policies in 2005. Following state mandated delays as a result of the four hurricanes that impacted Florida in 2004, the Company's non-renewal process resumed in the first quarter of 2005 and resulted in a full year reduction of approximately \$3 million and \$2 million in direct written premiums and direct earned premiums, respectively. In the Spring 2005 session, the Florida legislature implemented measures, including a single deductible per hurricane season and requiring up-front payment by insurance companies of full replacement cost, to address the impact of future and past multi-hurricane seasons. The impact on the Company of these measures is not determinable at the time of this Report on Form 10-K. In addition, an independent financial audit has determined a \$515 million deficit in the Citizens Property Insurance Corporation's ("Florida Citizens") high-risk account as a result of the four hurricanes in Florida in 2004. Following their installation in August 2005, the new Florida Citizens' board of governors approved a \$515 million assessment to replenish the surplus of Florida Citizens. Based on its market share, the Company was required to pay its portion of the assessment, \$1.8 million, in the third quarter of 2005 (reflected as a component of benefits, claims and settlement expenses) and will in turn assess its Florida property policyholders over the next 12-24 months to recoup this amount beginning in May 2006. The Company continues to evaluate and implement actions to further mitigate its exposure risk in Florida and other hurricane-prone coastal areas. Such actions could include, but are not limited to, non-renewal of homeowners policies, restricted agent geographic placement and further tightening of underwriting standards.

The Company also received a \$1.3 million assessment from the Louisiana Citizens Fair and Coastal Plan ("Louisiana Citizens") which was driven by hurricane catastrophe losses in that state in 2005. This assessment was paid by the Company in the fourth quarter of 2005 (reflected as a component of benefits, claims and settlement expenses) and the Company will in turn assess its Louisiana property policyholders to recoup this amount beginning in May 2006.

New annuity deposits decreased 2.1% in 2005 and increased 10.2% in 2004. The 2005 decline reflected a 9.2% increase in new scheduled annuity deposits offset by a 14.0% decrease in single premium and rollover deposits. While new deposits to fixed accounts decreased 6.5%, or \$12.7 million, compared to 2004 due to the current interest rate environment, new deposits to variable accounts increased 4.4%, or \$5.8 million, compared to 2004. The 2004 growth reflected an 18.1% increase in single premium and rollover deposits and a 3.7% increase in new scheduled annuity deposits. New deposits to fixed accounts were 7.6%, or \$13.7 million, higher than in 2003 and new deposits to variable accounts increased 14.5%, or \$16.7 million, compared to a year earlier.

In 2001, the Company began building a nationwide network of independent agents who comprise a second distribution channel for the Company's 403(b) tax-qualified annuity products. The independent agent distribution channel included 759 authorized agents at December 31, 2005. During 2005, this channel generated \$35.4 million in annualized new annuity sales for the Company compared to \$38.0 million in 2004, with the lack of growth in the current period reflecting the Company's efforts to change the product mix from this channel to more tax-qualified annuity sales. New annuity sales from this channel were \$38.1 million in 2003.

Total annuity accumulated cash value of \$3.3 billion at December 31, 2005 increased 7.0% compared to a year earlier, reflecting the increase from new business over the 12 months, continued favorable retention and improving financial markets compared to December 31, 2004. Total annuity accumulated cash value of \$3.1 billion at December 31, 2004 increased 11.2% compared to a year earlier, also reflecting the growth in sales over the 12 months, continued favorable retention and improving equity markets. At December 31, 2005, the number of annuity contracts outstanding of 162,000 increased 1.9%, or 3,000 contracts, compared to December 31, 2004. In 2004, the number of annuity contracts outstanding increased 3.9%, or 6,000 contracts.

Variable annuity accumulated balances were 6.3% higher at December 31, 2005 than at December 31, 2004, while annuity segment contract charges earned increased 7.2%, or \$1.2 million, compared to 2004. Variable annuity accumulated balances were 12.1% higher at December 31, 2004 than at December 31, 2003 and 2004 annuity segment contract charges earned increased 14.4%, or \$2.1 million, compared to 2003.

Life segment premiums and contract deposits declined 3.2%, or \$3.5 million, in 2005, reflecting the shift in new business mix toward partner company products. Life segment premiums and contract deposits declined 2.9%, or \$3.3 million, in 2004. The ordinary life insurance in force lapse ratio was 6.5% for the 12 months ended December 31, 2005, compared to 7.2% and 7.7% for the twelve months ended December 31, 2004 and 2003, respectively.

#### *Net Investment Income*

Pretax investment income of \$194.6 million for 2005 increased 1.7%, or \$3.2 million, (1.5%, or \$2.0 million, after tax) compared to 2004. Growth in the size of the investment portfolio more than offset a decrease of approximately \$4.0 million pretax in prepayment income along with a decline in the portfolio yield. Pretax investment income of \$191.4 million for 2004 increased 3.6%,

or \$6.7 million, (4.5%, or \$5.6 million, after tax) compared to the prior year. Average invested assets (excluding securities lending collateral) increased 7.8% during 2005 and 8.4% during 2004. The average pretax yield on the investment portfolio was 5.4% (3.7% after tax) for 2005, compared to a pretax yield of 5.7% (3.9% after tax) and 5.9% (4.0% after tax) for 2004 and 2003, respectively. Excluding the impact of prepayment income, the average 2004 pretax yield was 5.5% (3.8% after tax).

### Net Realized Investment Gains and Losses

Net realized investment gains were \$9.8 million for 2005 compared to net realized investment gains of \$12.2 million in 2004 and \$25.5 in 2003. In 2005, the Company recorded a fixed income security impairment of \$1.8 million related to securities from one automobile industry issuer. There were no impairment charges from the Company's fixed income security portfolio in 2004. For 2003, the Company recorded fixed income security impairment charges totaling \$12.5 million, \$6.2 million related to two of the Company's collateralized debt obligation ("CDO") securities, \$3.1 million related to one manufactured housing asset-backed security and the remaining \$3.2 million primarily related to two airline industry issuers. Gains realized in 2005 included \$1.9 million from sales of securities for which impairment charges were recorded in 2003. Gains realized in 2003 included \$16.1 million from sales of securities for which impairment charges were recorded in 2002. The net gains for 2005, 2004 and 2003 also reflected gains realized from ongoing investment portfolio management activity.

The table below presents the Company's fixed maturity securities portfolio as of December 31, 2005 by major asset class, including the ten largest sectors of the Company's corporate bond holdings.

|   | <u>Number of<br/>Issuers</u> | <u>Fair<br/>Value</u> | <u>Amortized<br/>Cost</u> | <u>Pretax<br/>Unrealized<br/>Gain(Loss)</u> |
|---|------------------------------|-----------------------|---------------------------|---|
| Corporate bonds   |                              |                       |                           |   |
| Banking and Finance .....                                 | 41                           | \$ 429.4              | \$ 418.0                  | \$11.4                                      |
| Energy .....  | 50                           | 219.8                 | 207.8                     | 12.0  |
| Utilities .....   | 28                           | 178.1                 | 172.8                     | 5.3   |
| Telecommunications .....                                  | 27                           | 158.7                 | 154.6                     | 4.1   |
| Health Care .....   | 25                           | 112.2                 | 112.5                     | (0.3)                                       |
| Insurance .....   | 13                           | 94.0                  | 90.0                      | 4.0   |
| Food and Beverage .....                                   | 20                           | 93.2                  | 91.2                      | 2.0   |
| Transportation .....                                      | 12                           | 87.4                  | 86.8                      | 0.6   |
| Real Estate .....   | 14                           | 75.2                  | 73.6                      | 1.6   |
| Broadcasting and Media .....                              | 23                           | 57.3                  | 56.0                      | 1.3   |
| All Other Corporates (1) .....                            | <u>153</u>                   | <u>489.4</u>          | <u>479.2</u>              | <u>10.2</u>                                 |
| Total corporate bonds .....                               | 406                          | 1,994.7               | 1,942.5                   | 52.2  |
| Mortgage-backed securities                                |                              |                       |                           |   |
| U.S. government and federally<br>sponsored agencies ..... | 436                          | 690.2                 | 700.0                     | (9.8)                                       |
| Other .....   | 18                           | 71.6                  | 71.0                      | 0.6   |
| Municipal bonds .....                                     | 171                          | 576.8                 | 571.2                     | 5.6   |
| Government bonds  |                              |                       |                           |   |
| U.S. ....   | 7                            | 272.2                 | 273.6                     | (1.4)                                       |
| Foreign .....   | 9                            | 31.3                  | 29.8                      | 1.5   |
| Collateralized debt obligations (2) .....                 | 3                            | 15.4                  | 15.3                      | 0.1   |
| Asset-backed securities .....                             | <u>11</u>                    | <u>51.1</u>           | <u>51.9</u>               | <u>(0.8)</u>                                |
| Total fixed maturity securities .....                     | <u>1,061</u>                 | <u>\$3,703.3</u>      | <u>\$3,655.3</u>          | <u>\$48.0</u>                               |

(1) The All Other Corporates category contains 19 additional industry classifications. Industry, Manufacturing; defense; building and materials; automobiles; consumer products and paper represented \$279.3 million of fair value at December 31, 2005, with the remaining 13 classifications each representing less than \$34 million of the fair value at December 31, 2005.

(2) All of the securities were rated investment grade by Standard and Poor's Corporation and/or Moody's Investors Service, Inc. at December 31, 2005.

At December 31, 2005, the Company's diversified fixed maturity portfolio consisted of 1,276 investment positions, issued by 1,061 entities, and totaled approximately \$3.7 billion in fair value. The portfolio was 94.4% investment grade, based on fair value, with an average quality rating of A+. At December 31, 2005, the portfolio had \$39.3 million pretax of total gross unrealized losses related to 545 positions. At December 31, 2004, the total pretax gross unrealized losses were \$8.8 million related to 178 positions. The following table provides information regarding fixed maturity securities that had an unrealized loss at December 31, 2005, including the length of time that the securities have continuously been in an unrealized loss position.

**Investment Positions With Unrealized Losses Segmented by Quality  
and Period of Continuous Unrealized Loss  
As of December 31, 2005**

|                                      | <u>Number of<br/>Positions</u> | <u>Fair<br/>Value</u> | <u>Amortized<br/>Cost</u> | <u>Pretax<br/>Unrealized<br/>Loss</u> |
|--------------------------------------|--------------------------------|-----------------------|---------------------------|---------------------------------------|
| <b>Investment grade</b>              |                                |                       |                           |                                       |
| 6 Months or less .....               | 222                            | \$1,233.8             | \$1,250.8                 | \$(17.0)                              |
| 7 through 12 months.....             | 62                             | 306.1                 | 313.6                     | (7.5)                                 |
| 13 through 24 months.....            | 61                             | 323.1                 | 332.3                     | (9.2)                                 |
| 25 through 36 months.....            | 12                             | 62.7                  | 65.8                      | (3.1)                                 |
| 37 through 48 months.....            | -                              | -                     | -                         | -                                     |
| Greater than 48 months.....          | -                              | -                     | -                         | -                                     |
| Total .....                          | <u>357</u>                     | <u>\$1,925.7</u>      | <u>\$1,962.5</u>          | <u>\$(36.8)</u>                       |
| <b>Non-investment grade</b>          |                                |                       |                           |                                       |
| 6 Months or less .....               | 112                            | \$ 56.8               | \$ 58.1                   | \$ (1.3)                              |
| 7 through 12 months.....             | 53                             | 27.9                  | 28.9                      | (1.0)                                 |
| 13 through 24 months.....            | 19                             | 6.2                   | 6.3                       | (0.1)                                 |
| 25 through 36 months.....            | -                              | -                     | -                         | -                                     |
| 37 through 48 months.....            | -                              | -                     | -                         | -                                     |
| Greater than 48 months.....          | -                              | -                     | -                         | -                                     |
| Total .....                          | <u>184</u>                     | <u>\$ 90.9</u>        | <u>\$ 93.3</u>            | <u>\$ (2.4)</u>                       |
| <b>Not rated</b>                     |                                |                       |                           |                                       |
| Total, all 37 through 48 months..... | <u>4</u>                       | <u>\$ 2.2</u>         | <u>\$ 2.3</u>             | <u>\$ (0.1)</u>                       |
| Grand total .....                    | <u>545</u>                     | <u>\$2,018.8</u>      | <u>\$2,058.1</u>          | <u>\$(39.3)</u>                       |

Of the investment positions with unrealized losses, no issuers had pretax unrealized losses greater than \$1.2 million. One security, issued by General Motors Corporation, was trading below 80% of book value (at 70.8% of the \$1.0 million amortized cost) at December 31, 2005. The Company views the decrease in value of all of the securities with unrealized losses at December 31, 2005 as temporary, expects recovery in fair value, anticipates continued payments under the terms of the securities, and has the intent and ability to hold these securities until maturity or a recovery in fair value occurs. Therefore, no impairment of these securities was recorded at December 31, 2005. Future changes in circumstances related to these and other securities could require subsequent recognition of other-than-temporary impairment losses. The Company's investment guidelines generally limit single corporate issuer concentrations to 1.0% of invested assets for "AA" or "AAA" rated securities, 0.75% of invested assets for "A" rated securities, 0.5% of invested assets for "BBB" rated securities, and 0.2% of invested assets for non-investment grade securities.

## Benefits, Claims and Settlement Expenses

|   | Year Ended<br>December 31, |                | Growth Over<br>Prior Year |                 | Year Ended<br>December 31, |
|---|----------------------------|----------------|---------------------------|-----------------|----------------------------|
|   | 2005                       | 2004           | Percent                   | Amount          | 2003                       |
| Property and casualty .....                                       | \$398.0                    | \$439.3        | -9.4%                     | \$(41.3)        | \$472.9                    |
| Annuity .....   | 0.8                        | 1.2            | -33.3%                    | (0.4)           | 0.8                        |
| Life .....  | 43.9                       | 43.9           | -                         | -               | 45.3                       |
| Total .....   | <u>\$442.7</u>             | <u>\$484.4</u> | -8.6%                     | <u>\$(41.7)</u> | <u>\$519.0</u>             |
| Property and casualty catastrophe<br>losses, included above ..... | <u>\$ 59.3</u>             | <u>\$ 70.5</u> | -15.9%                    | <u>\$(11.2)</u> | <u>\$ 33.2</u>             |

### Property and Casualty Claims and Claim Expenses

|   | Year Ended December 31, |                |                |
|---|-------------------------|----------------|----------------|
|   | 2005                    | 2004           | 2003           |
| Incurred claims and claim expenses:   |                         |                |                |
| Claims occurring in the current year .....  | \$411.1                 | \$435.5        | \$416.5        |
| Increase (decrease) in estimated reserves for claims<br>occurring in prior years (1): |                         |                |                |
| Policies written by the Company .....   | (13.1)                  | 3.8            | 58.3           |
| Business assumed from state reinsurance facilities .....                              | -                       | -              | (1.9)          |
| Total .....   | <u>(13.1)</u>           | <u>3.8</u>     | <u>56.4</u>    |
| Total claims and claim expenses incurred .....  | <u>\$398.0</u>          | <u>\$439.3</u> | <u>\$472.9</u> |
| Property and casualty loss ratio:   |                         |                |                |
| Total .....   | 72.4%                   | 78.3%          | 88.6%          |
| Effect of catastrophe costs, included above .....                                     | 11.9%                   | 13.2%          | 6.2%           |

(1) Shows the amounts by which the Company increased or decreased its reserves in each of the periods indicated for claims occurring in previous periods to reflect subsequent information on such claims and changes in their projected final settlement costs.

In 2005, the Company's benefits, claims and settlement expenses decreased compared to 2004, primarily reflecting improvements in non-catastrophe property and casualty current accident year trends, particularly in claim frequencies. In addition, while significant in both years, the Company's catastrophe losses decreased in 2005 compared to 2004. Development of prior years' property and casualty reserves had a \$13.1 million favorable effect on benefits, claims and settlement expenses for 2005 and a minimal adverse effect in 2004. The 2005 favorable development was the result of actual and remaining projected losses for prior years being below the level anticipated in the December 31, 2004 loss reserve estimate. The Company's benefits, claims and settlement expenses in 2003 reflected \$56.4 million of adverse development of prior years' property and casualty reserves and a notable level of catastrophe losses.

Catastrophe losses in 2005 and 2004 were largely attributed to hurricanes. Hurricane Katrina, with estimated gross losses of \$73 million, represented \$13 million, net of anticipated reinsurance recoveries. Net losses from Hurricanes Wilma and Rita were approximately \$15 million and \$11 million, respectively, while losses from Hurricane Dennis and storms in Minnesota were approximately \$5 million and \$6.5 million, respectively. In addition, 2005 catastrophe losses included assessments of \$1.8 million from Florida Citizens and \$1.3 million from Louisiana Citizens, as described in "Insurance Premiums and Contract Charges". The Company's net catastrophe losses incurred of \$70.5 million for the year ended December 31, 2004 were a record high level for the Company and primarily reflected losses from Hurricanes Charley, Frances, Ivan and Jeanne, which totaled \$64.2 million. Total incurred property and casualty catastrophe losses for 2003 included homeowners claims from the California wildfires, net of anticipated reinsurance recoveries, which represented \$12.0 million of the 2003 losses. Claims from Hurricane Isabel,

primarily in the homeowners line, represented an additional \$5.0 million of 2003 catastrophe losses.

The catastrophe amounts recorded in 2005 represent the estimated net losses both from claims reported to the Company and from future expected claims from policyholders with hurricane damage, as well as estimated reinsurance recoverables for Hurricane Katrina. These estimates are based upon information received through December 31, 2005 on claims that have been settled, on-site evaluations by loss adjusters and loss estimates from catastrophe modeling. Due to the magnitude and complexity of Hurricane Katrina, including limited access to certain portions of the affected areas, the preliminary nature of the information used to prepare the estimate and an uncertain legal and regulatory environment, there can be no assurance that the ultimate costs associated with this and other catastrophic events will not exceed the Company's current estimates. These estimates will be refined as necessary, as additional information becomes available.

In 2005, net favorable development of total reserves for property and casualty claims occurring in prior years was \$13.1 million reflecting favorable loss emergence trends in both voluntary automobile and property business. Adverse development of reserves net of reinsurance recoverables for property and casualty claims occurring in prior years was \$56.4 million for full year 2003, primarily related to automobile liability loss reserves from the 2001 and 2002 accident years, compared to adverse reserve development of \$3.8 million for 2004, which reflected additional information related to a single liability claim that occurred over 15 years ago. Additional information regarding the Company's property and casualty reserves and adverse development of prior years' reserves is included in the "Notes to Consolidated Financial Statements -- Note 3 -- Property and Casualty Unpaid Claims and Claim Expenses" listed on page F-1 of this report.

For 2005, the voluntary automobile loss ratio of 68.2% decreased by 2.4 percentage points compared to the loss ratio of 70.6% for full year 2004 including a 3.2 percentage point improvement due to the change in development of prior years' reserves. The homeowners loss ratio of 80.5% improved 16.4 percentage points compared to the 12 months ended December 31, 2004 reflecting an increase in average premium per policy; an improvement in non-catastrophe loss frequency as a result of loss containment initiatives such as tightened underwriting guidelines, deductible management, an aggressive reunderwriting program and benefits of the Company's claims initiatives, which have focused on loss and expense control; and a reduced level of catastrophe losses in 2005. Catastrophe costs represented 37.9 percentage points of the homeowners loss ratio for 2005, compared to 46.9 percentage points for 2004, representing a decrease of 9.0 percentage points. For 2003, the voluntary automobile loss ratio was 90.0%, including 14.6 percentage points due to the adverse development of prior years' reserves, and the homeowners loss ratio was 82.5%, including 20.5 percentage points attributable to catastrophe costs.

For the annuity segment, benefits decreased by a minimal amount compared to 2004. The Company's GAAP guaranteed minimum death benefits ("GMDB") reserve was \$0.7 million at December 31, 2005, compared to \$0.1 million at both December 31, 2004 and 2003.

## Interest Credited to Policyholders

|              | Year Ended<br>December 31, |                | Growth Over<br>Prior Year |              | Year Ended<br>December 31, |
|--------------|----------------------------|----------------|---------------------------|--------------|----------------------------|
|              | 2005                       | 2004           | Percent                   | Amount       | 2003                       |
| Annuity..... | \$ 81.5                    | \$ 75.7        | 7.7%                      | \$5.8        | \$ 71.3                    |
| Life.....    | 34.4                       | 33.0           | 4.2%                      | 1.4          | 31.7                       |
| Total.....   | <u>\$115.9</u>             | <u>\$108.7</u> | 6.6%                      | <u>\$7.2</u> | <u>\$103.0</u>             |

Compared to 2004, the 2005 increase in annuity segment interest credited reflected a 9.0% increase in average accumulated fixed deposits, partially offset by a 5 basis point decline in the average annual interest rate credited to 4.40%. Compared to 2003, the 2004 increase in annuity segment interest credited reflected a 10.1% increase in average accumulated fixed deposits, partially offset by an 18 basis point decline in the average annual interest rate credited to 4.45%. Life insurance interest credited increased in both 2005 and 2004 as a result of the growth in interest-sensitive life insurance reserves.

The net interest spread on fixed annuity account value on deposit measures the difference between the rate of income earned on the underlying invested assets and the rate of interest which policyholders are credited on their account values. Fixed annuity crediting rates were lowered throughout 2004 and 2003 to reflect the decline in the rate of income on invested assets caused by lower investment rates on new and reinvested funds. The net interest spreads for the years ended December 31, 2005 and 2004 were 128 basis points and 156 basis points, respectively. Excluding the benefit of prepayment income on a structured mortgage-backed security, the corresponding net interest spreads were 127 and 145 basis points.

As of December 31, 2005, fixed annuity account values totaled \$2.0 billion, including \$1.7 billion of deferred annuities. Approximately 20% of the deferred annuity account values had minimum guaranteed interest rates ranging from 3.0% to 4.0% while approximately 76% of account values had minimum guaranteed rates of 4.5% or greater. For \$1.6 billion of the deferred annuity account values, the credited interest rate was equal to the minimum guaranteed rate. Due to limitations on the Company's ability to further lower interest crediting rates, coupled with the potential for continued low interest rates in 2006, the Company expects to experience additional fixed annuity spread compression in future periods.

### Operating Expenses

In 2005, operating expenses decreased 1.1%, or \$1.5 million, compared to 2004, primarily reflecting benefits from the Company's expense control initiatives partially offset by timing differences between periods. The property and casualty expense ratio of 23.2% for 2005 increased 1.0 percentage point compared to the prior year, including this segment's portion of corporate-wide expense reductions offset somewhat by the effect on this ratio of higher current period catastrophe reinsurance reinstatement premiums. In 2004, operating expenses decreased 3.4%, or \$4.6 million, compared to 2003, reflecting favorable state income tax and premium tax accrual adjustments as well as benefits from the Company's expense control initiatives, partially offset by an increase in incentive compensation accruals. The property and casualty expense ratio was 22.2% in 2004 and 23.7% in 2003.

In 2001, the Company determined that it would freeze its defined benefit pension plan in 2002 and move to a defined contribution structure. Costs of transitioning to the new structure, based upon assumptions of future events, were \$4.8 million and \$6.2 million in 2003 and 2002, respectively. Those costs were largely as a result of settlement accounting provisions that were triggered by the higher retirement rate experienced by the Company, coupled with more retirees choosing lump sum distributions, as well as the impact of declines in the market value of the pension plan's assets in 2002 and 2001. Defined benefit pension expense was \$3.1 million in 2005 and is estimated to be approximately \$3 million for 2006.

The Company's policy with respect to funding the defined benefit pension plan is to contribute amounts which are actuarially determined to provide the plan with sufficient assets to meet future benefit payments consistent with the funding requirements of federal laws and regulations. In 2002, the Company contributed \$7.9 million to the defined benefit pension plan, which was greater than the \$1.8 million actuarially-determined required minimum amount, reflecting a degree of conservatism which the Company believed to be appropriate in light of the then current volatility in the financial markets. In 2005, 2004 and 2003, the Company contributed \$4.5 million, \$3.5 million and \$8.8 million, respectively, to the defined benefit pension plan, with those amounts also in excess of the required minimum amount. Based on assumptions at the time of this Report on Form 10-K, the Company anticipates contributing approximately \$7 million to the defined benefit pension plan in 2006. All defined benefit pension plan investments are set aside in a trust fund.

The Company offers long-term care insurance, variable and fixed interest rate universal life policies, equity indexed annuities and single premium immediate annuities, with three third-party vendors underwriting and bearing the risk of such insurance ("Life Partner Products") and the Company receiving a commission on the sale of that business. The volume of Life Partner Product sales by the Company's agents decreased somewhat during 2005. The amount of commissions received by the Company in 2005 in excess of costs for agent commissions and commission related expenses was approximately \$1.1 million, \$1.5 million and a minimal amount for the years ended December 31, 2005, 2004 and 2003, respectively.

#### *Amortization of Policy Acquisition Expenses and Intangible Assets*

For 2005, the combined amortization of policy acquisition expenses and intangible assets was \$76.6 million compared to \$76.0 million recorded in 2004 and \$69.3 million recorded in 2003. Amortization of intangible assets was \$5.1 million, \$6.0 million and \$5.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. The December 31, 2005 valuation of Annuity VIF resulted in a \$0.2 million decrease in amortization compared to a \$0.9 million increase at December 31, 2004 and no significant effect from a similar valuation at December 31, 2003.

Amortized policy acquisition expenses were \$71.5 million for 2005 compared to \$70.0 million for 2004 and \$64.3 million for 2003. The increase from 2003 to 2004 primarily reflected the impact of valuations of annuity and life deferred policy acquisition costs as quantified above. The December 31, 2005 valuation of annuity deferred policy acquisition costs resulted in a \$1.8 million increase in amortization compared to a \$1.2 million increase in amortization resulting from a similar valuation at December 31, 2004. For the life segment, the December 31, 2005 valuation of deferred policy acquisition costs resulted in a \$0.7 million decrease in amortization compared to a \$0.4 million increase from the 2004 valuation. The December 31, 2003 valuations of annuity and life deferred policy acquisition costs resulted in decreases of \$2.4 million and \$1.4 million, respectively. The remaining increases in amortized policy acquisition costs were due to scheduled amortization of capitalized costs.

## *Income Tax Expense*

The effective income tax rate on the Company's pretax income, including realized investment gains and losses, was 17.8%, 19.2% and 1.0% for the years ended December 31, 2005, 2004 and 2003, respectively. Income from investments in tax-advantaged securities reduced the effective income tax rate 8.0, 11.5 and 36.3 percentage points for the years ended December 31, 2005, 2004 and 2003, respectively. While the income from tax-advantaged securities increased somewhat from 2003 through 2005, the reduced level of taxable income in 2003 resulted in this having a more significant impact on the effective income tax rate for that year.

The Company records contingent tax liabilities for exposures from uncertain tax filing positions based upon management's assessment of the amounts that are probable of being sustained upon Internal Revenue Service ("IRS") audit. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. The Company has no unrecorded contingent tax exposures.

At December 31, 2005, the Company had federal income tax returns for the 2002 through 2004 tax years still open and subject to adjustment upon IRS examination. The Company has recorded \$3.4 million of contingent tax liabilities related to those open tax years.

In 2005, the Company recorded reductions in federal income tax expense of \$9.1 million due to favorable resolution of contingent tax liabilities (\$5.5 million in the corporate and other segment and \$3.6 million in the annuity segment) and recorded \$1.4 million of pretax income representing interest on federal income tax refunds received (\$0.9 million in the annuity segment and \$0.5 million in the other segments). In April 2005, the Company received refunds for tax years 1996 through 2001 from the IRS totaling \$8.1 million, an amount consistent with the Company's tax refund accruals related to those years. As a result of the receipt of IRS refunds for tax years 1996 and 1997, which were then deemed to be closed, the contingent tax liability related to those two years was eliminated, which resulted in a decrease in federal income tax expense of \$2.7 million in the second quarter of 2005. The remaining refunds received related to tax years 1998 through 2001, which were deemed to be closed on September 15, 2005, resulting in an additional reduction in the contingent tax liability related to those four years of \$6.4 million that was recorded in the third quarter of 2005.

## *Net Income*

For 2005, the Company's net income was significantly affected by catastrophe costs, yet still increased compared to the prior year, primarily reflecting improved property and casualty segment earnings. This improvement was driven by lower catastrophe costs, tightened underwriting standards and pricing actions taken in recent years, ongoing improvements in claims processes, cost containment initiatives and generally favorable non-catastrophe claims frequency trends. Net income in 2005 also benefited from favorable development of prior years' property and casualty claim reserves and the favorable resolution of tax liabilities for prior years, as described above.

For 2004, the Company's net income increased compared to 2003, primarily reflecting improved property and casualty segment earnings, partially offset by the record high level of catastrophe costs in 2004. This improvement was driven by pricing and underwriting actions taken over several preceding quarters, continuing favorable non-catastrophe claims frequency trends, ongoing improvements in claims processes and cost containment initiatives, along with minimal adverse development of prior years' reserves.

In 2003, net income was negatively impacted by adverse development and strengthening of prior years' property and casualty claim reserves as well as a notable level of catastrophe losses, partially offset by net realized gains on securities. These negative components were partially offset by the impact of property and casualty rate increases on earned premiums and favorable property loss results excluding the impact of catastrophes.

Net income by segment and net income per share were as follows:

|   | Year Ended<br>December 31, |                 | Growth Over<br>Prior Year |               | Year Ended<br>December 31, |
|---|----------------------------|-----------------|---------------------------|---------------|----------------------------|
|   | 2005                       | 2004            | Percent                   | Amount        | 2003                       |
| Analysis of net income (loss) by segment:                                   |                            |                 |                           |               |                            |
| Property and casualty .....   | \$ 45.0                    | \$ 27.6         | 63.0%                     | \$17.4        | \$ (17.8)                  |
| Annuity.....  | 15.1                       | 12.6            | 19.8%                     | 2.5           | 14.4                       |
| Life.....   | 13.4                       | 14.8            | -9.5%                     | (1.4)         | 13.4                       |
| Corporate and other (1) .....   | 3.8                        | 1.3             |                           | 2.5           | 9.0                        |
| Net income.....   | <u>\$ 77.3</u>             | <u>\$ 56.3</u>  | 37.3%                     | <u>\$21.0</u> | <u>\$ 19.0</u>             |
| Effect of catastrophe costs, after tax,<br>included above.....              | <u>\$(45.0)</u>            | <u>\$(49.1)</u> |                           | <u>\$ 4.1</u> | <u>\$(21.6)</u>            |
| Diluted:  |                            |                 |                           |               |                            |
| Net income per share.....   | <u>\$ 1.67</u>             | <u>\$ 1.25</u>  | 33.6%                     | <u>\$0.42</u> | <u>\$ 0.44</u>             |
| Weighted average number of shares<br>and equivalent shares (in millions) .. | 47.9                       | 47.3            | 1.3%                      | 0.6           | 42.9                       |
| Property and casualty combined ratio:                                       |                            |                 |                           |               |                            |
| Total.....  | 95.6%                      | 100.5%          |                           | -4.9%         | 112.3%                     |
| Effect of catastrophe costs,<br>included above .....                        | 12.3%                      | 13.4%           |                           | -1.1%         | 6.2%                       |

(1) The Corporate and Other segment includes interest expense on debt, realized investment gains and losses, certain public company expenses and other corporate level items. The Company does not allocate the impact of corporate level transactions to the insurance segments, consistent with management's evaluation of the results of those segments.

For the three years ended December 31, 2005, net income for the property and casualty segment increased as described above.

Compared to 2004, annuity segment net income for 2005 increased primarily as a result of the contingent income tax liability reduction of \$3.6 million, which more than offset the negative effect of valuations of deferred policy acquisition costs and GMDB reserves. Annuity segment net income for 2005 also reflected a decline in the interest margin. Compared to 2003, annuity segment net income for 2004 decreased as growth in contract fees, which was a result of growth in the underlying accumulated variable amounts on deposit, was more than offset by the negative impact of valuations of deferred policy acquisition costs and Annuity VIF.

Life segment net income for 2005 decreased compared to 2004 primarily as a result of an increase in the effective income tax rate recorded in 2005. Life segment net income for 2004 increased compared to 2003, due primarily to favorable mortality experience, growth in income from partner company product sales and improved group insurance earnings. The December 31, 2004 valuation of life deferred policy acquisition costs increased amortization, while similar valuations decreased amortization in 2005 and 2003.

For 2005, the change in net income for the corporate and other segment included a \$5.5 million reduction in federal income tax expense from the elimination of the contingent tax liability for the 1996 through 2001 tax years. The change in net income for this segment over the two years ended December 31, 2004 primarily reflected differences in the amount of realized investment gains and losses, including impairment charges recorded in 2003.

Return on shareholders' equity based on net income was 13%, 10% and 3% for the 12 months ended December 31, 2005, 2004 and 2003, respectively.

Based on results for the full year 2005, at the time of this Report on Form 10-K, management anticipates that 2006 full year net income before realized investment gains and losses will be within a range of \$1.65 to \$1.80 per share. This projection anticipates favorable underlying property and casualty underwriting results -- with a combined ratio in the low 90s -- and also reflects additional costs of approximately \$0.16 per share associated with an enhanced catastrophe reinsurance program, as described in "Business -- Property and Casualty Segment -- Property and Casualty Reinsurance". As described in "Critical Accounting Policies", certain of the Company's significant accounting measurements require the use of estimates and assumptions. As additional information becomes available, adjustments may be required. Those adjustments are charged or credited to income for the period in which the adjustments are made and may impact actual results compared to management's current estimate. A projection of net income including realized investment gains and losses is not accessible on a forward-looking basis because it is not possible to provide a reliable forecast of realized investment gains and losses, which can vary substantially from one period to another and may have a significant impact on net income.

## **Liquidity and Financial Resources**

### *Special Purpose Entities*

At December 31, 2005, 2004 and 2003, the Company did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or for other contractually narrow or limited purposes. As such, the Company is not exposed to any financing, liquidity, market or credit risk that could arise if the Company had engaged in such relationships.

### *Related Party Transactions*

The Company does not have any contracts or other transactions with related parties that are required to be reported under the applicable securities laws and regulations.

Ariel Capital Management, Inc., HMEC's largest shareholder with 21.4% of the common shares outstanding per their SEC filing on Form 13F as of December 31, 2005, is the investment adviser for two of the mutual funds offered to the Company's annuity customers. In addition, T. Rowe Price Associates, Inc., HMEC's fourth largest shareholder with 4.7% of the common shares outstanding per their SEC filing on Form 13F as of December 31, 2005, is the investment advisor for three of the mutual funds offered to the Company's annuity customers.

### *Investments*

Information regarding the Company's investment portfolio, which is comprised primarily of investment grade, fixed income securities, is located in "Results of Operations for the Three Years Ended December 31, 2005 -- Realized Investment Gains and Losses", "Business -- Investments" and in the "Notes to Consolidated Financial Statements -- Note 2 -- Investments" listed on page F-1 of this report.

## Cash Flow

The short-term liquidity requirements of the Company, within a 12-month operating cycle, are for the timely payment of claims and benefits to policyholders, operating expenses, interest payments and federal income taxes. Cash flow generated from operations has been, and is expected to be, adequate to meet the Company's operating cash needs in the next 12 months. Cash flow in excess of operational needs has been used to fund business growth, retire short-term debt, pay dividends to shareholders and repurchase shares of the Company's common stock. Long-term liquidity requirements, beyond one year, are principally for the payment of future insurance policy claims and benefits and retirement of long-term debt.

### Operating Activities

As a holding company, HMEC conducts its principal operations in the personal lines segment of the property and casualty and life insurance industries through its subsidiaries. HMEC's insurance subsidiaries generate cash flow from premium and investment income, generally well in excess of their immediate needs for policy obligations, operating expenses and other cash requirements. Cash provided by operating activities primarily reflects net cash generated by the insurance subsidiaries. For 2005, net cash provided by operating activities decreased slightly compared to 2004 including a higher level of debt interest expense paid.

Payment of principal and interest on debt, dividends to shareholders and parent company operating expenses are dependent upon the ability of the insurance subsidiaries to pay cash dividends or make other cash payments to HMEC, including tax payments pursuant to tax sharing agreements. Historical payments for fees related to the catastrophe-linked equity put option and reinsurance agreement, as well as the share repurchase program, also had this dependency. The insurance subsidiaries are subject to various regulatory restrictions which limit the amount of annual dividends or other distributions, including loans or cash advances, available to HMEC without prior approval of the insurance regulatory authorities. Dividends which may be paid by the insurance subsidiaries to HMEC during 2006 without prior approval are approximately \$74 million. Although regulatory restrictions exist, dividend availability from subsidiaries has been, and is expected to be, adequate for HMEC's capital needs.

### Investing Activities

HMEC's insurance subsidiaries maintain significant investments in fixed maturity securities to meet future contractual obligations to policyholders. In conjunction with its management of liquidity and other asset/liability management objectives, the Company, from time to time, will sell fixed maturity securities prior to maturity and reinvest the proceeds in other investments with different interest rates, maturities or credit characteristics. Accordingly, the Company has classified the entire fixed maturity securities portfolio as "available for sale".

### Financing Activities

Financing activities include primarily payment of dividends, the receipt and withdrawal of funds by annuity contractholders, repurchases of the Company's common stock, fluctuations in bank overdraft balances, and borrowings, repayments and repurchases related to its debt facilities. Fees related to the catastrophe-linked equity put option and reinsurance agreement, which through May 7, 2005 augmented the Company's traditional reinsurance program, were charged directly to additional paid-in capital.

In June 2005, the Company issued \$75.0 million aggregate principal amount of 6.05% senior notes which will mature on June 15, 2015 ("Senior Notes due 2015") at a discount of 0.05%. The net proceeds from the sale of the Senior Notes due 2015 were used to (1) repay the \$25.0 million balance outstanding on the Bank Credit Facility, (2) redeem all of the Senior Notes due 2006 at an aggregate cost of \$29.1 million and (3) make a capital contribution to HMEC's primary life insurance subsidiary to substantially offset the early recapture of the Company's life reinsurance agreement with the United States branch of Sun Life Assurance Company of Canada. See also "Capital Resources" for additional description of the Senior Notes due 2015 and the recapture of the life reinsurance agreement.

For the year ended December 31, 2005, receipts from annuity contracts decreased 2.1%. Annuity contract benefits and withdrawals increased 29.1% compared to 2004. Cash value retentions for variable and fixed annuity options were 91.5% and 94.5%, respectively, for the 12 month period ended December 31, 2005. Net transfers to variable annuity accumulated cash values increased \$9.0 million, or 7.9%, compared to 2004.

### Contractual Obligations

|  | Payments Due By Period As of December 31, 2005 |                               |                                   |                                   |  |
|--|--|-------------------------------|-----------------------------------|-----------------------------------|--|
|  | Total  | Less Than<br>1 Year<br>(2006) | 1 - 3 Years<br>(2007 and<br>2008) | 3 - 5 Years<br>(2009 and<br>2010) | More Than<br>5 Years<br>(2011 and<br>beyond) |
| Short-term Debt Obligations (1):                     |  |                               |                                   |                                   |  |
| Bank Credit Facility (expires<br>May 30, 2009) ..... | -  | -                             | -                                 | -                                 | -  |
| Long-Term Debt Obligations (1):                      |  |                               |                                   |                                   |  |
| Senior Convertible Notes                             |  |                               |                                   |                                   |  |
| Due May 14, 2032 (2).....                            | \$249.7  | \$ 3.5                        | \$ 1.7                            | \$ -                              | \$244.5                                      |
| Senior Notes Due June 15, 2015.....                  | 118.1  | 4.5                           | 9.1                               | 9.1                               | 95.4   |
| Operating lease obligations (3) .....                | 7.8  | 4.5                           | 3.1                               | 0.2                               | -  |
| Purchase obligations.....                            | <u>0.5</u>                                     | <u>0.5</u>                    | -                                 | -                                 | -  |
| Total.....   | <u>\$376.1</u>                                 | <u>\$13.0</u>                 | <u>\$13.9</u>                     | <u>\$9.3</u>                      | <u>\$339.9</u>                               |

(1) Includes principal and interest.

(2) Holders of the Senior Convertible Notes may require HMEC to purchase all or a portion of their Senior Convertible Notes on either May 14, 2007, 2012, 2017, 2022, or 2027 as further described in "Notes to Consolidated Financial Statements -- Note 4 -- Debt" listed on page F-1 of this report.

(3) The Company has entered into various operating lease agreements, primarily for real estate (agency and claims offices across the country and portions of the home office complex) and also for computer equipment.

## Future Policy Benefits and Claims - Life and Annuity Segments

The following table summarizes the Company's contractual obligations and commitments as of December 31, 2005 expected to be paid in the periods presented. Payment amounts reflect the Company's estimate of undiscounted cash flows related to these obligations and commitments. Balance sheet amounts were determined in accordance with GAAP and in many cases differ significantly from the summation of undiscounted cash flows. The most significant difference relates to future policy benefits related to life insurance, which includes discounting.

|   | <u>Estimated Payments by Period As of December 31, 2005</u> |  |  |  |  |
|---|---|--|--|--|--|
|   | <u>Total</u>  | <u>Less Than<br/>1 Year<br/>(2006)</u> | <u>1 - 3 Years<br/>(2007 and<br/>2008)</u> | <u>3 - 5 Years<br/>(2009 and<br/>2010)</u> | <u>More Than<br/>5 Years<br/>(2011 and<br/>beyond)</u> |
| Fixed annuities and fixed option<br>of variable annuities ..... | \$3,168.4   | \$107.9                                | \$244.3                                    | \$263.5                                    | \$2,552.7  |
| Supplemental contracts.....                                     | 289.1   | 36.5                                   | 59.0                                       | 44.3                                       | 149.3  |
| Life insurance.....   | <u>2,202.9</u>  | <u>70.4</u>                            | <u>147.5</u>                               | <u>148.1</u>                               | <u>1,836.9</u>   |
| Total .....   | <u>\$5,660.4</u>  | <u>\$214.8</u>                         | <u>\$450.8</u>                             | <u>\$455.9</u>                             | <u>\$4,538.9</u>                                       |

A significant portion of policy contract benefits to be paid do not have stated contractual maturity dates and may not result in any ultimate payment obligation. Amounts reported herein represent estimated undiscounted cash flows out of the Company's general account related to death, surrender, annuity and other benefit payments under policy contracts in force at December 31, 2005. Separate account payments are not reflected herein due to the matched nature of these obligations and the fact that the contract owners maintain the investment risk of such deposits. Estimated payment amounts reported herein were developed based on review of historical results experienced by the Company and the related contractual provisions. Significant assumptions incorporated in the reported amounts include: future policy lapse rates (including the impact of customer decisions to make future premium payments to keep the related policies in force), coverage levels remaining unchanged from those provided under contracts in force at December 31, 2005, future interest crediting rates, and the estimated timing of payments. Actual amounts will vary, potentially in a significant manner, from the amounts indicated due to deviations between assumptions and actual results and the addition of new business in future periods.

Assumptions for future interest crediting levels have been made based on processes consistent with the Company's past practices, which are at the discretion of the Company, subject to guaranteed minimum crediting rates in many cases and/or subject to contractually obligated rates for specified periods of time. Many of the contracts with potentially accelerated timing of payments are subject to surrender charges which are generally calculated as a percentage of account values withdrawn and are assessed at declining rates during the first five to ten years after contract issuance. Amounts disclosed herein include an estimate of those accelerated payments, net of applicable surrender charges. See "Note 1 -- Summary of Significant Accounting Policies -- Future Policy Benefits, Interest-sensitive Life Contract Liabilities and Annuity Contract Liabilities" listed on page F-1 of this report for a description of the Company's method for establishing life and annuity reserves in accordance with GAAP.

For annuity estimated payments, certain assumptions have been made about retirement patterns in the amounts reported. Actual retirements may differ significantly from those projected and may result in early withdrawal of contract funds, which could cause the timing of the obligations reported to vary significantly. In addition, contractual surrender provisions exist on an immaterial portion of these contracts that could decrease and/or accelerate those obligations presented.

## Estimated Claims and Claim Related Payments - Property and Casualty Segment

The table below presents the amount and estimated future timing of claims and claim related payments for property and casualty insurance. Both the total liability and the estimated payments are based on actuarial projection techniques, at a given accounting date. These estimates include assumptions of the ultimate settlement and administrative costs based on the Company's assessment of facts and circumstances then known, review of historical settlement patterns, estimates of trends in claims severity, frequency and other factors. Variables in the reserve estimation process can be affected by both internal and external events, such as changes in claims handling procedures, economic inflation, legal trends and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. Additionally, there may be significant reporting lags between the occurrence of a claim and the time it is actually reported to the Company. The future cash flows related to the items contained in the table below required estimation of both amount (including severity considerations) and timing. Amount and timing are frequently estimated separately. An estimation of both amount and timing of future cash flows related to claims and claim related payments is generally reliable only in the aggregate with some unavoidable estimation uncertainty.

The following table includes estimated future claims and claims related payments, net of the estimated reinsurance recoveries, where applicable, at December 31, 2005. The amounts reported in the table are presented on a nominal basis and have not been discounted.

| <b>Estimated Payments by Period As of December 31, 2005</b> |              |  |  |  |  |
|---|--------------|--|--|--|--|
|   | <b>Total</b> | <b>Less Than<br/>1 Year<br/>(2006)</b> | <b>1 - 3 Years<br/>(2007 and<br/>2008)</b> | <b>3 - 5 Years<br/>(2009 and<br/>2010)</b> | <b>More Than<br/>5 Years<br/>(2011 and<br/>beyond)</b> |
| Claims and claim adjustment expenses .....                  | \$311.1      | \$166.9                                | \$116.9                                    | \$24.0                                     | \$3.3  |

The amounts in "Claims and claim adjustment expenses" in the table above represent the estimated timing of future payments for both reported and unreported claims incurred and related claim adjustment expenses, net of reinsurance recoverables. Therefore, estimated future payments include cash inflows related to the Company's reinsurance arrangements. Since the timing and amount of cash inflows from such reinsurance agreements are highly correlated to the underlying payment of claims and claim adjustment expenses by the Company, the analysis above presents the estimated cash outlay for reported and unreported claims incurred and related claim adjustment expense, net of reinsurance.

### *Capital Resources*

The Company has determined the amount of capital which is needed to adequately fund and support business growth, primarily based on risk-based capital formulas including those developed by the National Association of Insurance Commissioners ("NAIC"). Historically, the Company's insurance subsidiaries have generated capital in excess of such needed capital. These excess amounts have been paid to HMEC through dividends. HMEC has then utilized these dividends and its access to the capital markets to service and retire long-term debt, pay dividends to its shareholders, fund growth initiatives, repurchase shares of its common stock and for other corporate purposes. Management anticipates that the Company's sources of capital will continue to generate capital in excess of the needs for business growth, debt interest payments and shareholder dividends.

The total capital of the Company was \$771.5 million at December 31, 2005, including \$190.9 million of long-term debt and no short-term debt outstanding. Total debt represented 25.7% of total capital excluding unrealized investment gains and losses (24.7% including unrealized investment gains and losses) at December 31, 2005, slightly above the Company's long-term target of 25%.

Shareholders' equity was \$580.6 million at December 31, 2005, including a net unrealized gain in the Company's investment portfolio of \$28.4 million after taxes and the related impact on deferred policy acquisition costs and the value of acquired insurance in force associated with annuity and interest-sensitive life policies. The market value of the Company's common stock and the market value per share were \$814.7 million and \$18.96, respectively, at December 31, 2005. Book value per share was \$13.51 at December 31, 2005 (\$12.85 excluding investment fair value adjustments).

As of December 31, 2005, the Company had outstanding \$244.5 million aggregate principal amount of 1.425% Senior Convertible Notes ("Senior Convertible Notes"), which will mature on May 14, 2032, issued at a discount of 52.5% resulting in an effective yield of 3.0%. Interest on the Senior Convertible Notes is payable semi-annually at a rate of 1.425% from November 14, 2002 until May 14, 2007. After that date, cash interest will not be paid on the Senior Convertible Notes prior to maturity unless contingent cash interest becomes payable. From May 15, 2007 through maturity of the Senior Convertible Notes, interest will be recognized at the effective rate of 3.0% and will represent the accrual of discount, excluding any contingent cash interest that may become payable. Contingent cash interest becomes payable if the average market price of a Senior Convertible Note for a five-trading-day measurement period preceding the applicable six-month period equals 120% or more of the sum of the Senior Convertible Note's issue price, accrued original issue discount and accrued cash interest, if any, for such Senior Convertible Note. The contingent cash interest payable per Senior Convertible Note with respect to any quarterly period within any six-month period will equal the then applicable conversion rate multiplied by the greater of (1) \$0.105 or (2) any regular cash dividends paid by the Company per share on HMEC's common stock during that quarterly period. In September 2002, the Company's Board of Directors authorized the Company to repurchase, from time to time, for cash or other consideration, its Senior Convertible Notes. Holders of the Senior Convertible Notes may require HMEC to purchase all or a portion of their Senior Convertible Notes on either May 14, 2007, 2012, 2017, 2022, or 2027 as further described in "Notes to Consolidated Financial Statements -- Note 4 -- Debt". Detailed information regarding the conversion and redemption terms of the Senior Convertible Notes is contained in the "Notes to Consolidated Financial Statements -- Note 4 -- Debt" listed on page F-1 of this report.

The Senior Convertible Notes have an investment grade rating from Standard & Poor's Corporation ("S&P") (BBB), Moody's Investors Service, Inc. ("Moody's") (Baa3), and A.M. Best Company, Inc. ("A.M. Best") (bbb-). See also "Financial Ratings". The Senior Convertible Notes are traded in the open market (HMN 1.425).

On June 9, 2005, the Company issued \$75.0 million face amount of senior notes at an effective yield of 6.1%, which will mature on June 15, 2015 ("Senior Notes due 2015"). Interest on the Senior Notes due 2015 is payable semi-annually at a rate of 6.05%. The Senior Notes due 2015 are redeemable in whole or in part, at any time, at the Company's option, at a redemption price equal to the greater of (1) 100% of their principal amount or (2) the sum of the present values of the remaining scheduled payments of principal and interest thereon discounted, on a semi-annual basis, at the Treasury yield (as defined in the indenture) plus 30 basis points, plus, in either of the above cases, accrued interest to the date of redemption. For information regarding the use of proceeds, see "Liquidity and Financial Resources -- Cash Flow -- Financing Activities".

The Senior Notes due 2015 have an investment grade rating from S&P (BBB), Moody's (Baa3), and A.M. Best (bbb-). See also "Financial Ratings". The Senior Notes due 2015 are traded in the open market (HMN 6.05).

On June 30, 2005, the Company redeemed all of its outstanding \$28.6 million aggregate principal amount of 6 5/8% Senior Notes due 2006 ("Senior Notes due 2006"). For information regarding the funding of the redemption, see "Liquidity and Financial Resources -- Cash Flow -- Financing Activities".

As of December 31, 2005, the Company had no balance outstanding under its Bank Credit Agreement. On May 31, 2005, the Company entered into a new Bank Credit Agreement which provides for unsecured borrowings of up to \$100.0 million (the "Current Bank Credit Facility"). The Current Bank Credit Facility expires on May 30, 2009. Interest accrues at varying spreads relative to corporate or Eurodollar base rates and is payable monthly or quarterly depending on the applicable base rate. The unused portion of the Current Bank Credit Facility is subject to a variable commitment fee, which was 0.175% on an annual basis at December 31, 2005. On May 31, 2005, the Company borrowed \$25.0 million under the Current Bank Credit Facility and subsequently repaid this balance in full on June 13, 2005 utilizing a portion of the proceeds from the issuance of the Senior Notes due 2015.

On May 29, 2002, Horace Mann Educators Corporation entered into a Bank Credit Agreement that was amended effective June 1, 2004, increasing the commitment amount to \$35.0 million, and May 3, 2005, extending the commitment termination date to June 30, 2005 from the previous termination date of May 31, 2005 (the "Previous Bank Credit Agreement"). The Previous Bank Credit Agreement was terminated on May 31, 2005, when the Company entered into the Current Bank Credit Facility. The \$25.0 million balance outstanding under the Previous Bank Credit Agreement was repaid in full on May 31, 2005 utilizing the borrowing under the Current Bank Credit Facility, described above.

To provide additional capital management flexibility, the Company filed a "universal shelf" registration on Form S-3 with the SEC in December 2003. The registration statement, which registers the offer and sale by the Company from time to time of up to \$300 million of various securities, which may include debt securities, preferred stock, common stock and/or depository shares, was declared effective on December 30, 2003. The \$75.0 million face amount of Senior Notes due 2015 was issued utilizing this registration statement. No other securities associated with the registration statement have been issued as of the date of this Report on Form 10-K.

The Company's ratio of earnings to fixed charges (with fixed charges including interest credited to policyholders on interest-sensitive contracts) for the years ended December 31, 2005, 2004 and 2003 was 1.8x, 1.6x and 1.2x, respectively. See also "Exhibit 12 -- Statement Regarding Computation of Ratios". The Company's ratio of earnings before interest expense to interest expense was 11.6x, 11.2x and 4.0x for the years ended December 31, 2005, 2004 and 2003, respectively.

Total shareholder dividends were \$18.2 million for the year ended December 31, 2005. In March 2006, the Board of Directors announced a regular quarterly dividend of \$0.105 per share.

Information regarding the reinsurance program for the Company's property and casualty segment is located in "Business -- Property and Casualty Segment -- Property and Casualty Reinsurance".

On December 31, 2003, the Company's primary life insurance subsidiary, Horace Mann Life Insurance Company ("HMLIC"), entered into a reinsurance agreement with the United States branch of Sun Life Assurance Company of Canada ("SLACC") which replaced the 2002 agreement with Sun Life Reinsurance Company Limited, a member of the Sun Life Financial Group. Under the terms of the December 31, 2003 agreement, which was written to be in place for a five year period, HMLIC ceded to SLACC, on a combination coinsurance and modified coinsurance basis, a 75% quota share of HMLIC's in force interest-sensitive life block of business issued prior to January 1, 2002. SLACC assumed its proportional share of all risks attendant to the business reinsured such as mortality, persistency and investment risk, reducing HMLIC's liabilities under statutory accounting principles to the extent of the ceded commission. The initial ceded commission received by HMLIC was \$50.0 million and resulted in a \$32.5 million after-tax increase in HMLIC's statutory surplus. These transactions improved the statutory operating leverage and risk-based capital ratio of HMLIC in 2004, 2003 and 2002, but did not impact reported GAAP capitalization. The agreement provided that HMLIC could recapture the agreement without penalty after giving 30 days written notice. In the third quarter of 2005, a portion of the proceeds from the issuance of the Senior Notes due 2015 was utilized to make a capital contribution to HMEC's primary life insurance subsidiary to substantially offset the early recapture of the reinsurance agreement with SLACC. This agreement was terminated effective July 1, 2005 for a minimal recapture fee. This early recapture resulted in the reduction of total anticipated pretax fees of approximately \$1.2 million, including \$0.2 million in the fourth quarter of 2005, \$0.5 million in 2006 and the remainder over subsequent years. At the time of this Report on Form 10-K, the Company has no financial reinsurance agreements in effect.

## **Financial Ratings**

The Company's principal insurance subsidiaries are rated by Standard & Poor's Corporation ("S&P"), Moody's Investors Service, Inc. ("Moody's") and A.M. Best Company, Inc. ("A.M. Best"). These rating agencies have also assigned ratings to the Company's long-term debt securities.

Assigned ratings as of March 1, 2006 were as follows (the insurance financial strength ratings for the Company's property and casualty insurance subsidiaries and the Company's principal life insurance subsidiary are the same):

| <u>As of March 1, 2006</u> | <u>Insurance<br/>Financial<br/>Strength Ratings<br/>(Outlook)</u> | <u>Debt Ratings<br/>(Outlook)</u> |
|----------------------------|---|-----------------------------------|
| S&P (1) .....              | A (stable)  | BBB (stable)                      |
| Moody's (1) .....          | A3 (stable)   | Baa3 (stable)                     |
| A.M. Best .....            | A- (stable)   | bbb- (stable)                     |

(1) This agency has not yet rated Horace Mann Lloyds.

The ratings above were unchanged from the disclosure in the Company's Annual Report on Form 10-K for 2004. In June 2005, all three of the rating agencies affirmed their debt ratings as they assigned a rating to the Senior Notes due 2015.

### Market Value Risk

Market value risk, the Company's primary market risk exposure, is the risk that the Company's invested assets will decrease in value. This decrease in value may be due to a change in (1) the yields realized on the Company's assets and prevailing market yields for similar assets, (2) an unfavorable change in the liquidity of the investment, (3) an unfavorable change in the financial prospects of the issuer of the investment, or (4) a downgrade in the credit rating of the issuer of the investment. See also "Results of Operations for the Three Years Ended December 31, 2005 -- Net Realized Investment Gains and Losses".

Significant changes in interest rates expose the Company to the risk of experiencing losses or earning a reduced level of income based on the difference between the interest rates earned on the Company's investments and the credited interest rates on the Company's insurance liabilities. See also "Results of Operations for the Three Years Ended December 31, 2005 -- Interest Credited to Policyholders".

The Company seeks to manage its market value risk by coordinating the projected cash inflows of assets with the projected cash outflows of liabilities. For all its assets and liabilities, the Company seeks to maintain reasonable durations, consistent with the maximization of income without sacrificing investment quality, while providing for liquidity and diversification. The investment risk associated with variable annuity deposits and the underlying mutual funds is assumed by those contractholders, and not by the Company. Certain fees that the Company earns from variable annuity deposits are based on the market value of the funds deposited.

Through active investment management, the Company invests available funds with the objective of funding future obligations to policyholders, subject to appropriate risk considerations, and maximizing shareholder value. This objective is met through investments that (1) have similar characteristics to the liabilities they support; (2) are diversified among industries, issuers and geographic locations; and (3) are predominately investment-grade fixed maturity securities classified as available for sale. No derivatives are used to manage the exposure to interest rate risk in the investment portfolios. At December 31, 2005, approximately 20% of the fixed investment portfolio represented investments supporting the property and casualty operations and

approximately 80% supported the life and annuity business. For discussions regarding the Company's investments see "Results of Operations for the Three Years Ended December 31, 2005 -- Net Realized Investment Gains and Losses" and "Business -- Investments".

The Company's life and annuity earnings are affected by the spreads between interest yields on investments and rates credited or accruing on life and fixed annuity insurance liabilities. Although substantially all credited rates on fixed annuities may be changed annually (subject to minimum guaranteed rates), competitive pricing and other factors, including the impact on the level of surrenders and withdrawals, may limit the Company's ability to adjust or to maintain crediting rates at levels necessary to avoid narrowing of spreads under certain market conditions. See also "Results of Operations for the Three Years Ended December 31, 2005 -- Interest Credited to Policyholders".

Using financial modeling and other techniques, the Company regularly evaluates the appropriateness of investments relative to the characteristics of the liabilities that they support. Simulations of cash flows generated from existing business under various interest rate scenarios measure the potential gain or loss in fair value of interest-rate sensitive assets and liabilities. Such estimates are used to closely match the duration of assets to the duration of liabilities. The overall duration of liabilities of the Company's multiline insurance operations combines the characteristics of its long duration interest-sensitive life and annuity liabilities with its short duration non-interest-sensitive property and casualty liabilities. Overall, at December 31, 2005, the duration of both the fixed income securities portfolio and the Company's insurance liabilities was estimated to be approximately 6 years.

The life and annuity operations participate in the cash flow testing procedures imposed by statutory insurance regulations, the purpose of which is to insure that such liabilities are adequate to meet the Company's obligations under a variety of interest rate scenarios. Based on these procedures, the Company's assets and the investment income expected to be received on such assets are adequate to meet the insurance policy obligations and expenses of the Company's insurance activities in all but the most extreme circumstances.

The Company periodically evaluates its sensitivity to interest rate risk. Based on commonly used models, the Company projects the impact of interest rate changes, assuming a wide range of factors, including duration and prepayment, on the fair value of assets and liabilities. Fair value is estimated based on the net present value of cash flows or duration estimates. At December 31, 2005, assuming an immediate decrease of 100 basis points in interest rates, the net fair value of the Company's assets and liabilities would increase by approximately \$17 million after tax, or 3% of shareholders' equity. A 100 basis point increase would decrease the fair value of assets and liabilities by approximately \$31 million after tax, or 5% of shareholders' equity. At December 31, 2004, assuming an immediate decrease of 100 basis points in interest rates, the net fair value of the Company's assets and liabilities would have increased by approximately \$22 million after tax, or 3% of shareholders' equity. A 100 basis point increase would have decreased the fair value of assets and liabilities by approximately \$39 million after tax, or 6% of shareholders' equity at December 31, 2004. In each case, these changes in interest rates assume a parallel shift in the yield curve.

While the Company believes that these assumed market rate changes are reasonably possible, actual results may differ, particularly as a result of any management actions that would be taken to mitigate such hypothetical losses in fair value of shareholders' equity. Based on the Company's overall exposure to interest rate risk, the Company believes that these changes in interest rates would not materially affect its consolidated near-term financial position, results of operations or cash flows.

### **Recent Accounting Changes**

#### *FSP No. FAS 115-1*

In November 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. FAS 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments", which nullifies the guidance in paragraphs 10-18 of EITF Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" and references existing other-than-temporary impairment guidance. This FSP is effective for reporting periods beginning after December 15, 2005. FSP No. 115-1 clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell the security has not been made, and also provides guidance on the subsequent accounting for an impaired debt security. The Company's existing accounting policy is consistent with the accounting guidance clarified by this FSP and, as a result, its adoption is not expected to have a material effect on the results of operations or financial position of the Company.

#### *SOP 05-1*

In October 2005, the American Institute of Certified Public Accountants issued Statement Of Position ("SOP") 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts". SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs ("DAC") on internal replacements of insurance and investment contracts other than those specifically 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. This SOP will be effective for internal replacements occurring in fiscal years beginning after December 15, 2006. Management believes the Company's accounting policy for internal replacements is generally consistent with the accounting guidance prescribed in SOP 05-1. Management is currently assessing the impact of the SOP on the Company's results of operations and financial position.

In May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, "Accounting Changes and Error Corrections". This standard will be effective for accounting changes and corrections of errors in fiscal years beginning after December 15, 2005. SFAS No. 154 replaces Accounting Principles Board Opinion No. 20, "Accounting Changes", and FASB SFAS No. 3, "Reporting Changes in Interim Financial Statements". SFAS No. 154 changes the accounting for, and reporting of, a change in accounting principle and also requires retrospective application to prior period's financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. At the time of this Report on Form 10-K, management is not aware of outstanding circumstances that would result in a currently quantifiable impact on the Company's operating results or financial position.

*SFAS No. 123 (revised 2004) ("SFAS No. 123(R)"), SAB 107 and SEC Release 34-51558*

In April 2005, the Securities and Exchange Commission ("SEC") issued Release No. 34-51558, "Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for SFAS No. 123 (Revised 2004), 'Share-Based Payment'". This amendment to Regulation S-X states that each registrant that is not a small business issuer will be required to adopt the provisions of SFAS No. 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005, which for the Company will be January 1, 2006. Release No. 34-51558 does not change the accounting required by SFAS No. 123(R); it changes only the dates for compliance with the Standard.

In March 2005, the SEC released Staff Accounting Bulletin ("SAB") No. 107 which summarizes the views of the SEC staff regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations and provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

In December 2004, the FASB issued SFAS No. 123(R) and, as issued by the FASB, this standard was to be effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 for public entities that do not file as small business issuers, which for the Company was to be July 1, 2005. See discussion above regarding the delay in the effective date. This statement revises SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and its related implementation guidance. SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and identifies required disclosures for share-based payment arrangements. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. In addition, the statement addresses the accounting and financial statement presentation for income tax benefits resulting from share-based payments.

This statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions and requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award. That cost will be recognized as expense in the Consolidated Statement of Operations over the period during which an employee is required to provide service in exchange for the award.

The Company has accounted for share-based payments using the intrinsic value based method in accordance with APB Opinion No. 25 and, accordingly, recognized no compensation expense for awards representing options to purchase shares of the Company's common stock which have an exercise price equal to market price on the date of grant resulting in an intrinsic value of \$0. Disclosures regarding the pro forma effect of stock-based compensation expense have been included in the Company's quarterly and annual consolidated financial statements in compliance with SFAS No. 123. Excluding the acceleration of stock option vesting which occurred in 2004, pro forma pretax stock-based compensation expense was approximately \$7 million to \$8 million in each of the three years ended December 31, 2004. At the time of this Report on Form 10-K management anticipates that the impact of adopting SFAS No. 123(R) will be comparable to the historical pro forma expense assuming that the number and characteristics of equity instruments granted in the future are similar to past awards.

### **Effects of Inflation and Changes in Interest Rates**

The Company's operating results are affected significantly in at least three ways by changes in interest rates and inflation. First, inflation directly affects property and casualty claims costs. Second, the investment income earned on the Company's investment portfolio and the fair value of the investment portfolio are related to the yields available in the fixed-income markets. An increase in interest rates will decrease the fair value of the investment portfolio, but will increase investment income as investments mature and proceeds are reinvested at higher rates. Third, as interest rates increase, competitors will typically increase crediting rates on annuity and interest-sensitive life products, and may lower premium rates on property and casualty lines to reflect the higher yields available in the market. The risk of interest rate fluctuation is managed through asset/liability management techniques, including cash flow analysis.

# REPORT OF MANAGEMENT RESPONSIBILITY FOR FINANCIAL STATEMENTS

## Horace Mann Educators Corporation

The consolidated balance sheets of Horace Mann Educators Corporation and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive income, changes in shareholders' equity, and cash flows for the years ended December 31, 2005, 2004 and 2003 have been prepared by management, which is responsible for their integrity and reliability. The statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include some amounts that are based upon management's best estimates and judgements. Management has discussed with the Audit Committee the quality, not just the acceptability, of the Company's accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the Company's accounting policies and their application, and the clarity and completeness of the Company's consolidated financial statements, which include related disclosures. The financial information contained elsewhere in this Annual Report on Form 10-K is consistent with that contained in the consolidated financial statements.

Management is responsible for establishing and maintaining a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting. The concept of reasonable assurance is based on the recognition that there are inherent limitations in all systems of internal control, and that the cost of such systems should not exceed the benefits derived therefrom. A professional staff of internal auditors reviews on an ongoing basis the related internal control system design, the accounting policies and procedures supporting this system and compliance therewith. Management believes this system of internal control effectively meets its objective of reliable financial reporting. See also "Management's Report on Internal Control Over Financial Reporting" included in "Item 9A. Controls and Procedures" listed in the Index to this Annual Report on Form 10-K.

In connection with their annual audits, the independent registered public accounting firm performs an audit, in accordance with the standards of the Public Company Accounting Oversight Board (United States), which includes the consideration of the system of internal control to the extent necessary to form an independent opinion on the fairness of presentation of the consolidated financial statements prepared by management.

The Board of Directors, through its Audit Committee composed solely of independent directors, is responsible for overseeing the integrity and reliability of the Company's accounting and financial reporting practices and the effectiveness of its system of internal controls. The independent registered public accounting firm and internal auditors meet regularly with this committee, and have access to this committee with and without management present, to discuss the results of their audit work.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders  
Horace Mann Educators Corporation:

We have audited the accompanying consolidated balance sheets of Horace Mann Educators Corporation and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005. In connection with our audits of the consolidated financial statements, we also have audited financial statement schedules I to IV and VI. These consolidated financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules 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, 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 the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related 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.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, 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 March 15, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

**KPMG LLP**

KPMG LLP

Chicago, Illinois  
March 15, 2006

**HORACE MANN EDUCATORS CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

**As of December 31, 2005 and 2004**

(Dollars in thousands)

|   | <u>2005</u>        | <u>2004</u>        |
|---|--------------------|--------------------|
| <b>ASSETS</b>   |                    |                    |
| Investments   |                    |                    |
| Fixed maturities, available for sale, at fair value   |                    |                    |
| Fixed maturities (amortized cost 2005, \$3,466,276;<br>2004, \$3,399,254).....                                    | \$3,513,451        | \$3,541,255        |
| Fixed maturity securities on loan (amortized cost<br>2005, \$189,008; 2004, \$0).....                             | <u>189,851</u>     | <u>-</u>           |
| Total fixed maturities.....   | 3,703,302          | 3,541,255          |
| Short-term and other investments.....   | 100,195            | 115,835            |
| Short-term investments, loaned securities collateral.....   | <u>192,995</u>     | <u>142</u>         |
| Total investments.....  | 3,996,492          | 3,657,232          |
| Accrued investment income and premiums receivable.....  | 103,141            | 104,530            |
| Deferred policy acquisition costs.....  | 233,630            | 209,576            |
| Goodwill.....   | 47,396             | 47,396             |
| Value of acquired insurance in force.....   | 16,322             | 21,522             |
| Other assets.....   | 109,936            | 76,883             |
| Separate Account (variable annuity) assets.....   | <u>1,333,690</u>   | <u>1,254,763</u>   |
| Total assets.....   | <u>\$5,840,607</u> | <u>\$5,371,902</u> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                    |                    |
| Policy liabilities  |                    |                    |
| Fixed annuity contract liabilities.....   | \$1,818,997        | \$1,688,075        |
| Interest-sensitive life contract liabilities.....   | 617,708            | 593,694            |
| Unpaid claims and claim expenses.....   | 350,761            | 342,445            |
| Future policy benefits.....   | 182,997            | 181,648            |
| Unearned premiums.....  | <u>201,594</u>     | <u>204,706</u>     |
| Total policy liabilities.....   | 3,172,057          | 3,010,568          |
| Other policyholder funds.....   | 146,078            | 142,634            |
| Liability for securities lending agreements.....  | 191,870            | -                  |
| Other liabilities.....  | 225,435            | 218,011            |
| Short-term debt.....  | -                  | 25,000             |
| Long-term debt.....   | 190,886            | 144,720            |
| Separate Account (variable annuity) liabilities.....  | <u>1,333,690</u>   | <u>1,254,763</u>   |
| Total liabilities.....  | <u>5,260,016</u>   | <u>4,795,696</u>   |
| Preferred stock, \$0.001 par value, authorized<br>1,000,000 shares; none issued.....                              | -                  | -                  |
| Common stock, \$0.001 par value, authorized 75,000,000<br>shares; issued, 2005, 60,475,399; 2004, 60,350,014..... | 60                 | 60                 |
| Additional paid-in capital.....   | 345,251            | 343,178            |
| Retained earnings.....  | 553,712            | 494,665            |
| Accumulated other comprehensive income (loss), net of taxes:  |                    |                    |
| Net unrealized gains on fixed maturities and equity securities.....   | 28,446             | 85,872             |
| Minimum pension liability adjustment.....   | (14,301)           | (14,992)           |
| Treasury stock, at cost, 2005 and 2004, 17,503,371 shares.....  | <u>(332,577)</u>   | <u>(332,577)</u>   |
| Total shareholders' equity.....   | <u>580,591</u>     | <u>576,206</u>     |
| Total liabilities and shareholders' equity.....   | <u>\$5,840,607</u> | <u>\$5,371,902</u> |

See accompanying notes to consolidated financial statements.

**HORACE MANN EDUCATORS CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME**

(Dollars in thousands, except per share data)

|  | Year Ended December 31, |            |            |
|--|-------------------------|------------|------------|
|  | 2005                    | 2004       | 2003       |
| <b>Revenues</b>  |                         |            |            |
| Insurance premiums and contract charges earned...              | \$ 664,939              | \$ 674,704 | \$ 643,536 |
| Net investment income .....                                    | 194,632                 | 191,448    | 184,725    |
| Realized investment gains .....                                | 9,841                   | 12,197     | 25,487     |
| Total revenues .....   | 869,412                 | 878,349    | 853,748    |
| <b>Benefits, losses and expenses</b>                           |                         |            |            |
| Benefits, claims and settlement expenses .....                 | 442,717                 | 484,410    | 518,978    |
| Interest credited .....  | 115,861                 | 108,668    | 102,970    |
| Policy acquisition expenses amortized .....                    | 71,463                  | 70,001     | 64,345     |
| Operating expenses .....                                       | 131,305                 | 132,704    | 137,318    |
| Amortization of intangible assets .....                        | 5,141                   | 5,990      | 5,027      |
| Interest expense .....   | 8,881                   | 6,819      | 6,339      |
| Restructuring charge adjustments .....                         | -                       | -          | (408)      |
| Total benefits, losses and expenses .....                      | 775,368                 | 808,592    | 834,569    |
| Income before income taxes .....                               | 94,044                  | 69,757     | 19,179     |
| Income tax expense .....                                       | 16,771                  | 13,444     | 204        |
| Net income .....   | \$ 77,273               | \$ 56,313  | \$ 18,975  |
| <b>Earnings per share</b>                                      |                         |            |            |
| Basic .....  | \$ 1.80                 | \$ 1.32    | \$ 0.44    |
| Diluted .....  | \$ 1.67                 | \$ 1.25    | \$ 0.44    |
| <b>Weighted average number of shares and equivalent shares</b> |                         |            |            |
| Basic .....  | 42,912,630              | 42,762,348 | 42,712,822 |
| Diluted .....  | 47,884,739              | 47,346,636 | 42,904,167 |
| <b>Comprehensive income</b>                                    |                         |            |            |
| Net income .....   | \$ 77,273               | \$ 56,313  | \$ 18,975  |
| Other comprehensive income (loss), net of tax:                 |                         |            |            |
| Change in net unrealized gains                                 |                         |            |            |
| on fixed maturities and equity securities .....                | (57,426)                | 4,264      | 1,041      |
| Change in minimum pension liability adjustment ..              | 691                     | 2,260      | 13         |
| Other comprehensive income (loss) .....                        | (56,735)                | 6,524      | 1,054      |
| Total .....  | \$ 20,538               | \$ 62,837  | \$ 20,029  |

See accompanying notes to consolidated financial statements.

**HORACE MANN EDUCATORS CORPORATION**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(Dollars in thousands, except per share data)

|  | Year Ended December 31, |                   |                   |
|--|-------------------------|-------------------|-------------------|
|  | 2005                    | 2004              | 2003              |
| Common stock   |                         |                   |                   |
| Beginning balance .....  | \$ 60                   | \$ 60             | \$ 60             |
| Options exercised, 2005, 124,624 shares;<br>2004, 104,192 shares .....                                 | -                       | -                 | -                 |
| Conversion of Director Stock Plan units, 2005, 761<br>shares; 2004, 20,511 shares; 2003, 30,696 shares | -                       | -                 | -                 |
| Ending balance .....   | 60                      | 60                | 60                |
| Additional paid-in capital   |                         |                   |                   |
| Beginning balance .....  | 343,178                 | 342,306           | 342,749           |
| Options exercised and conversion of Director<br>Stock Plan units .....                                 | 2,073                   | 1,997             | 645               |
| Catastrophe-linked equity put option premium .....   | -                       | (1,125)           | (1,088)           |
| Ending balance .....   | 345,251                 | 343,178           | 342,306           |
| Retained earnings  |                         |                   |                   |
| Beginning balance .....  | 494,665                 | 456,330           | 455,308           |
| Net income .....   | 77,273                  | 56,313            | 18,975            |
| Cash dividends, \$0.42 per share .....   | (18,226)                | (17,978)          | (17,953)          |
| Ending balance .....   | 553,712                 | 494,665           | 456,330           |
| Accumulated other comprehensive income,<br>net of taxes:   |                         |                   |                   |
| Beginning balance .....  | 70,880                  | 64,356            | 63,302            |
| Change in net unrealized gains on fixed<br>maturities and equity securities .....                      | (57,426)                | 4,264             | 1,041             |
| Change in minimum pension liability adjustment ....  | 691                     | 2,260             | 13                |
| Ending balance .....   | 14,145                  | 70,880            | 64,356            |
| Treasury stock, at cost  |                         |                   |                   |
| Beginning and ending balance,<br>2005, 2004 and 2003, 17,503,371 shares .....                          | (332,577)               | (332,577)         | (332,577)         |
| Shareholders' equity at end of period .....  | <b>\$ 580,591</b>       | <b>\$ 576,206</b> | <b>\$ 530,475</b> |

See accompanying notes to consolidated financial statements.

**HORACE MANN EDUCATORS CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

|  | <u>Year Ended December 31,</u> |                  |                  |
|--|--------------------------------|------------------|------------------|
|  | <u>2005</u>                    | <u>2004</u>      | <u>2003</u>      |
| <b>Cash flows - operating activities</b>                                 |                                |                  |                  |
| Premiums collected.....  | \$ 683,505                     | \$ 690,903       | \$ 684,331       |
| Policyholder benefits paid.....  | (482,753)                      | (489,321)        | (496,208)        |
| Policy acquisition and<br>other operating expenses paid.....             | (221,790)                      | (220,312)        | (221,499)        |
| Federal income taxes recovered (paid) .....                              | 1,096                          | (3,933)          | (19,001)         |
| Investment income collected.....   | 192,373                        | 188,692          | 185,359          |
| Interest expense paid.....   | (8,275)                        | (5,955)          | (5,454)          |
| Contribution to defined benefit pension<br>plan trust fund .....         | (4,514)                        | (3,500)          | (8,780)          |
| Other .....  | 5,524                          | 10,704           | 3,086            |
| Net cash provided by operating activities .....                          | <u>165,166</u>                 | <u>167,278</u>   | <u>121,834</u>   |
| <b>Cash flows - investing activities</b>                                 |                                |                  |                  |
| Fixed maturities   |                                |                  |                  |
| Purchases .....  | (984,433)                      | (1,270,699)      | (1,762,957)      |
| Sales .....  | 467,653                        | 679,958          | 922,699          |
| Maturities .....   | 258,637                        | 321,704          | 560,915          |
| Net cash (used in) provided by<br>short-term and other investments ..... | <u>16,856</u>                  | <u>(11,393)</u>  | <u>35,437</u>    |
| Net cash used in investing activities .....                              | <u>(241,287)</u>               | <u>(280,430)</u> | <u>(243,906)</u> |
| <b>Cash flows - financing activities</b>                                 |                                |                  |                  |
| Dividends paid to shareholders.....                                      | (18,226)                       | (17,978)         | (17,953)         |
| Principal borrowings (repayments)<br>on Bank Credit Facility .....       | (25,000)                       | -                | 25,000           |
| Exercise of stock options .....  | 2,055                          | 1,592            | -                |
| Catastrophe-linked equity put option premium .....                       | -                              | (1,125)          | (1,088)          |
| Proceeds from issuance of Senior<br>Notes due 2015.....                  | 74,245                         | -                | -                |
| Repurchase of Senior Notes due 2006.....                                 | (29,077)                       | -                | -                |
| Annuity contracts, variable and fixed<br>Deposits .....                  | 320,063                        | 326,976          | 296,615          |
| Benefits and withdrawals .....   | (126,536)                      | (98,034)         | (92,791)         |
| Net transfer to Separate Account<br>(variable annuity) assets .....      | (123,120)                      | (114,081)        | (113,074)        |
| Net decrease in life policy account balances .....                       | (4,457)                        | (5,157)          | (10,600)         |
| Change in bank overdrafts.....   | 6,174                          | 20,959           | 34,484           |
| Net cash provided by financing activities .....                          | <u>76,121</u>                  | <u>113,152</u>   | <u>120,593</u>   |
| Net decrease in cash .....   | -                              | -                | (1,479)          |
| Cash at beginning of period .....  | -                              | -                | <u>1,479</u>     |
| Cash at end of period .....  | <u>\$ -</u>                    | <u>\$ -</u>      | <u>\$ -</u>      |

See accompanying notes to consolidated financial statements.

# HORACE MANN EDUCATORS CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

### NOTE 1 - Summary of Significant Accounting Policies

#### *Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with United States ("U.S.") generally accepted accounting principles ("GAAP") and with the rules and regulations of the Securities and Exchange Commission ("SEC"). The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The consolidated financial statements include the accounts of Horace Mann Educators Corporation and its wholly-owned subsidiaries ("HMEC"; and together with its subsidiaries, the "Company" or "Horace Mann"). HMEC and its subsidiaries have common management, share office facilities and are parties to several intercompany service agreements for management, administrative, data processing, agent commissions, agency services, utilization of personnel and investment advisory services. Under these agreements, costs have been allocated among the companies in conformity with customary insurance accounting practices consistently applied. In addition, certain of the subsidiaries have entered into intercompany reinsurance agreements. HMEC and its subsidiaries file a consolidated federal income tax return, and there are related tax sharing agreements. The tax sharing agreements provide that tax on income is charged to the subsidiaries as if they were filing separate federal income tax returns and the subsidiaries receive the benefits of any losses or tax credits to the extent utilized in the consolidated return. All significant intercompany balances and transactions have been eliminated in consolidation.

The subsidiaries of HMEC market and underwrite tax-qualified retirement annuities and private passenger automobile, homeowners, and life insurance products, primarily to educators and other employees of public schools and their families. The Company's principal operating subsidiaries are Horace Mann Life Insurance Company, Horace Mann Insurance Company, Teachers Insurance Company, Horace Mann Property & Casualty Insurance Company and Horace Mann Lloyds.

#### *Investments*

The Company invests primarily in fixed maturity investments. These securities are classified as available for sale and carried at fair value. The net adjustment for unrealized gains and losses on securities available for sale, carried at fair value, is recorded as a separate component of shareholders' equity, net of applicable deferred tax asset or liability and the related impact on deferred policy acquisition costs and value of acquired insurance in force associated with interest-sensitive life and annuity contracts.

## **NOTE 1 - Summary of Significant Accounting Policies-(Continued)**

Short-term and other investments are comprised of policy loans, carried at unpaid principal balances; short-term fixed interest securities, carried at cost which approximates fair value; mortgage loans, carried at unpaid principal less a valuation allowance for estimated uncollectible amounts; real estate acquired in the settlement of debt, carried at the lower of cost or fair value; and equity securities, carried at fair value.

Interest income is recognized as earned. Investment income reflects amortization of premiums and accrual of discounts on an effective-yield basis.

Realized gains and losses arising from the sale or impairment of securities are determined based upon specific identification of securities. The Company reviews the fair value of all investments in its portfolio on a monthly basis to assess whether an other-than-temporary decline in value has occurred. These reviews, in conjunction with the Company's investment managers' monthly credit reports and relevant factors such as (1) the financial condition and near-term prospects of the issuer, (2) the Company's ability or intent to retain the investment long enough to allow for the anticipated recovery in fair value, (3) the stock price trend of the issuer, (4) the market leadership position of the issuer, (5) the debt ratings of the issuer and (6) the cash flows of the issuer, are all considered in the impairment assessment. A write-down of an investment is recorded when a decline in the fair value of that investment is deemed to be other-than-temporary, with a realized investment loss charged to income for the period.

The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Based on these facts, if management believes it is probable that amounts due will not be collected according to the contractual terms of a debt security not impaired at acquisition, or if the Company does not have the ability or intent to hold a security with an unrealized loss until it matures or recovers in value, an other-than-temporary impairment shall be considered to have occurred. As a general rule, if the fair value of a debt security has fallen below 80% of book value for more than six months, this security will be reviewed for an other-than-temporary impairment. Additionally, if events become known that call into question whether the security issuer has the ability to honor its contractual commitments, whether or not such security has been trading above an 80% fair value to book value relationship, such security holding will be evaluated to determine whether or not such security has suffered an other-than-temporary decline in value.

## **NOTE 1 - Summary of Significant Accounting Policies-(Continued)**

A decline in fair value below amortized cost is not assumed to be other-than-temporary for fixed maturity investments with unrealized losses due to market conditions or industry-related events where there exists a reasonable expectation that fair value will recover versus historical cost and the Company has the intent and ability to hold the investment until maturity or a market recovery is realized. Management believes that its intent and ability to hold a fixed maturity investment with a continuous material unrealized loss due to market conditions or industry-related events for a period of time sufficient to allow a market recovery or to maturity is a decisive factor when considering an impairment loss. In the event that the Company's intent or ability to hold a fixed maturity investment with a continuous unrealized loss for a period of time sufficient to allow a market recovery or to maturity were to change, an evaluation for other-than-temporary impairment is performed. An other-than-temporary impairment loss will be recognized based upon all relevant facts and circumstances for each investment, as appropriate, in accordance with Securities and Exchange Commission Staff Accounting Bulletin ("SAB") No. 59, "Accounting for Non-Current Marketable Equity Securities", and No. 104, "Revenue Recognition", Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities", and related guidance.

### *Deferred Policy Acquisition Costs*

Policy acquisition costs, consisting of commissions, policy issuance and other costs, which vary with and are primarily related to the production of insurance business, are capitalized and amortized on a basis consistent with the type of insurance coverage. Capitalized acquisition costs for interest-sensitive life contracts are amortized over 20 years in proportion to estimated gross profits. For other individual life contracts, acquisition costs are amortized in proportion to anticipated premiums over the terms of the insurance policies (10, 15 and 20 years). For all investment (annuity) contracts, acquisition costs are amortized over 20 years in proportion to estimated gross profits. For property and casualty policies, acquisition costs are amortized over the terms of the insurance policies (six and twelve months). The Company periodically reviews the assumptions and estimates used in capitalizing policy acquisition costs and also periodically reviews its estimations of gross profits. The most significant assumptions that are involved in the estimation of annuity gross profits include future financial market performance, interest rate spreads, business surrender/lapse rates and the impact of realized investment gains and losses. In the event actual experience differs significantly from assumptions or assumptions are significantly revised, the Company may be required to record a material charge or credit to amortization expense for the period in which the adjustment is made.

Deferred policy acquisition costs for interest-sensitive life and investment contracts are adjusted for the impact on estimated future gross profits as if net unrealized investment gains and losses had been realized at the balance sheet date. The impact of this adjustment is included in net unrealized gains and losses within shareholders' equity.

Deferred policy acquisition costs are reviewed for recoverability from future income, including investment income, and costs which are deemed unrecoverable are expensed in the period in which the determination is made. No such costs have been deemed unrecoverable during the periods reported.

## NOTE 1 - Summary of Significant Accounting Policies-(Continued)

### *Value of Acquired Insurance In Force and Goodwill*

When the Company was acquired in 1989, intangible assets were recorded in the application of purchase accounting to recognize the value of acquired insurance in force and goodwill. In addition, goodwill was recorded in 1994 related to the purchase of Horace Mann Property & Casualty Insurance Company. The value of acquired insurance in force is being amortized over the following periods, utilizing the indicated methods for life and annuity, respectively, as follows: 20 years, in proportion to coverage provided; 20 years, in proportion to estimated gross profits.

Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets". The Company's value of acquired insurance in force is an intangible asset with a definite life and will continue to be amortized under the provisions of SFAS No. 142. Goodwill will remain on the consolidated balance sheet and not be amortized. SFAS No. 142 established a new method of testing goodwill for impairment. On an annual basis, and when there is reason to suspect that its value may have been diminished or impaired, the goodwill asset must be tested for impairment. The amount of goodwill determined to be impaired will be expensed to current operations. During each year from 2002 through 2005, the Company completed the required testing under SFAS No. 142; no impairment charges were necessary as a result of such assessments.

The allocation of goodwill by segment is as follows:

|                             |                 |
|-----------------------------|-----------------|
| Annuity .....               | \$28,025        |
| Life .....                  | 9,911           |
| Property and casualty ..... | 9,460           |
| Total .....                 | <u>\$47,396</u> |

For the amortization of the value of acquired insurance in force, the Company periodically reviews its estimates of gross profits. The most significant assumptions that are involved in the estimation of gross profits include future financial market performance, interest rate spreads, business surrender/lapse rates and the impact of realized investment gains and losses. In the event actual experience differs significantly from assumptions or assumptions are significantly revised, the Company may be required to record a material charge or credit to amortization expense for the period in which the adjustment is made.

The value of acquired insurance in force for investment contracts is adjusted for the impact on estimated future gross profits as if net unrealized investment gains and losses had been realized at the balance sheet date. The impact of this adjustment is included in net unrealized gains and losses within shareholders' equity.

## NOTE 1 - Summary of Significant Accounting Policies-(Continued)

The balances of value of acquired insurance in force by segment at December 31, 2005 and 2004 were as follows:

|   | December 31, 2005 |                          |                 | December 31, 2004 |                          |                 |
|---|-------------------|--------------------------|-----------------|-------------------|--------------------------|-----------------|
|   | Cost              | Accumulated Amortization | Net Balance     | Cost              | Accumulated Amortization | Net Balance     |
| Life .....  | \$ 48,746         | \$ 44,499                | \$ 4,247        | \$ 48,746         | \$ 43,039                | \$ 5,707        |
| Annuity .....                                       | <u>87,553</u>     | <u>74,791</u>            | <u>12,762</u>   | <u>87,553</u>     | <u>71,110</u>            | <u>16,443</u>   |
| Subtotal .....                                      | <u>\$136,299</u>  | <u>\$119,290</u>         | <u>17,009</u>   | <u>\$136,299</u>  | <u>\$114,149</u>         | <u>22,150</u>   |
| Impact of unrealized investment gains and losses .. |                   |                          | <u>(687)</u>    |                   |                          | <u>(628)</u>    |
| Total .....   |                   |                          | <u>\$16,322</u> |                   |                          | <u>\$21,522</u> |

Expected amortization of the December 31, 2005 balances of value of acquired insurance in force by segment over the next five years is as follows:

| Expected amortization of value of acquired insurance in force | Year Ended December 31, |                |                |              |             |
|---|-------------------------|----------------|----------------|--------------|-------------|
|   | 2006                    | 2007           | 2008           | 2009         | 2010        |
| Life .....  | \$1,394                 | \$1,338        | \$1,292        | \$223        | \$ -        |
| Annuity .....   | <u>3,967</u>            | <u>4,336</u>   | <u>4,459</u>   | <u>-</u>     | <u>-</u>    |
| Total .....   | <u>\$5,361</u>          | <u>\$5,674</u> | <u>\$5,751</u> | <u>\$223</u> | <u>\$ -</u> |

The amount of interest accrued on the unamortized balance of value of acquired insurance in force and the interest accrual rates were as follows:

| Interest accrued on the unamortized balance of value of acquired insurance in force | Year Ended December 31, |                |                |
|---|-------------------------|----------------|----------------|
|   | 2005                    | 2004           | 2003           |
| Life .....  | \$ 398                  | \$ 518         | \$ 645         |
| Annuity .....   | <u>722</u>              | <u>921</u>     | <u>1,185</u>   |
| Total .....   | <u>\$1,120</u>          | <u>\$1,439</u> | <u>\$1,830</u> |
| Interest accrual rate   |                         |                |                |
| Life .....  | 8.0%                    | 8.0%           | 8.0%           |
| Annuity .....   | 5.1%                    | 5.2%           | 5.3%           |

The accumulated amortization of intangibles as of December 31, 2005 and 2004 was \$168,267 and \$163,126, respectively.

### Property and Equipment

Property and equipment are carried at cost less accumulated depreciation and are included in Other Assets in the Consolidated Balance Sheets. Depreciation and amortization are calculated on the straight-line method based on the estimated useful lives of the assets. The estimated useful lives of property and equipment by asset type are generally as follows: real estate, identified by specific property, 20-45 years; furniture, 10 years; general office machines, 6 years; telephones, 5 years; vehicles, 3 years; and data processing hardware and software and personal computers, 3 years.

|                                      | December 31,    |                 |
|--------------------------------------|-----------------|-----------------|
|                                      | 2005            | 2004            |
| Property and equipment .....         | \$75,969        | \$70,965        |
| Less: accumulated depreciation ..... | <u>53,389</u>   | <u>49,401</u>   |
| Total .....                          | <u>\$22,580</u> | <u>\$21,564</u> |

## **NOTE 1 - Summary of Significant Accounting Policies-(Continued)**

### *Separate Accounts (Variable Annuity) Assets and Liabilities*

Separate account (variable annuity) assets, carried at market value, and liabilities represent variable annuity funds invested in various mutual funds. The investment income, gains and losses of these accounts accrue directly to the policyholders and are not included in the operations of the Company.

### *Future Policy Benefits, Interest-sensitive Life Contract Liabilities and Annuity Contract Liabilities*

Liabilities for future benefits on life and annuity policies are established in amounts adequate to meet the estimated future obligations on policies in force. Liabilities for future policy benefits on certain life insurance policies are computed using the net level premium method and are based on assumptions as to future investment yield, mortality and withdrawals. As a result of the application of purchase accounting, future policy benefits for direct individual life insurance policies issued through August 29, 1989 were revalued using interest rates of 9% graded to 8% over 10 years. For policies issued from August 30, 1989 through December 31, 1992, future policy benefits are computed using an interest rate of 6.5%. An interest rate of 5.5% is used to compute future policy benefits for policies issued after December 31, 1992. Mortality and withdrawal assumptions for all policies have been based on actuarial tables which are consistent with the Company's own experience. Liabilities for future benefits on annuity contracts and certain long-duration life insurance contracts are carried at accumulated policyholder values without reduction for potential surrender or withdrawal charges. The liability also includes provisions for the unearned portion of certain policy charges.

A guaranteed minimum death benefit ("GMDB") generally provides a benefit if the annuitant dies and the contract value is less than a contractually defined amount. The Company has established a GMDB reserve on variable annuity contracts. Contractually defined amounts vary from contract to contract based on the date the contract was entered into as well as the GMDB feature elected by the contractholder. The Company regularly monitors the GMDB reserve considering fluctuations in the financial markets. At December 31, 2005 and 2004, the GMDB reserve was \$705 and \$73, respectively. The Company has a relatively low exposure to GMDB because approximately 23% of contract values have no guarantee; approximately 71% have only a return of premium guarantee; and approximately 6% have a guarantee of premium roll-up at an annual interest rate of 3% or 5%. The aggregate in-the-money death benefits under the GMDB provision totaled \$24,238 and \$26,494 at December 31, 2005 and 2004, respectively.

## **NOTE 1 - Summary of Significant Accounting Policies-(Continued)**

### *Unpaid Claims and Claim Expenses*

Liabilities for property and casualty unpaid claims and claim expenses include provisions for payments to be made on reported claims, claims incurred but not reported and associated settlement expenses. At December 31, 2005, all of the Company's reserves for property and casualty unpaid claims and claim expenses were carried at the full value of estimated liabilities and were not discounted for interest expected to be earned on reserves. Estimated amounts of salvage and subrogation on unpaid property and casualty claims are deducted from the liability for unpaid claims. Due to the nature of the Company's personal lines business, the Company has no exposure to claims for toxic waste cleanup, other environmental remediation or asbestos-related illnesses other than claims under homeowners insurance policies for environmentally related items such as mold.

### *Insurance Premiums and Contract Charges Earned*

Property and casualty insurance premiums are recognized as revenue ratably over the related contract periods in proportion to the risks insured. The unexpired portions of these property and casualty premiums are recorded as unearned premiums, using the monthly pro rata method.

Premiums and contract charges for interest-sensitive life and annuity contracts consist of charges for the cost of insurance, policy administration and withdrawals. Premiums for long-term traditional life policies are recognized as revenues when due over the premium-paying period. Annuity and interest-sensitive life contract deposits represent funds deposited by policyholders and are not included in the Company's premiums or contract charges earned.

### *Stock Based Compensation*

The Company grants stock options to executive officers, other employees and directors. The exercise price of the option is equal to the fair market value of the Company's common stock on the date of grant. Additional information regarding the Company's stock-based compensation plans is contained in Note 5 -- Shareholders' Equity and Stock Options. The Company accounts for stock option grants using the intrinsic value based method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and accordingly, recognizes no compensation expense for the stock option grants which have an exercise price equal to market price on the date of grant resulting in an intrinsic value of \$0.

## NOTE 1 - Summary of Significant Accounting Policies-(Continued)

Alternatively, SFAS No. 123, "Accounting for Stock-Based Compensation", allows companies to recognize compensation cost for stock-based compensation plans, determined based on the fair value at the grant dates. If the Company had applied this alternative accounting method, net income and net income per share would have been reduced to the pro forma amounts indicated below:

|   | Year Ended December 31, |                 |                 |
|---|-------------------------|-----------------|-----------------|
|   | 2005                    | 2004            | 2003            |
| Net income  |                         |                 |                 |
| As reported.....  | \$77,273                | \$56,313        | \$18,975        |
| Add: Stock-based compensation expense,<br>after tax, included in reported net income .....                                      | -                       | -               | -               |
| Deduct: Stock-based compensation expense,<br>after tax, determined under the fair value<br>based method for all awards (1)..... | 46                      | 10,971          | 5,368           |
| Pro forma .....   | <u>\$77,227</u>         | <u>\$45,342</u> | <u>\$13,607</u> |
| Net income per share – basic  |                         |                 |                 |
| As reported.....  | \$ 1.80                 | \$ 1.32         | \$ 0.44         |
| Pro forma .....   | \$ 1.80                 | \$ 1.06         | \$ 0.32         |
| Net income per share – diluted  |                         |                 |                 |
| As reported.....  | \$ 1.67                 | \$ 1.25         | \$ 0.44         |
| Pro forma .....   | \$ 1.67                 | \$ 1.02         | \$ 0.32         |

(1) The fair value of each option grant was estimated on the date of grant using the Modified Roll-Geske option-pricing model with the following weighted average assumptions for 2005, 2004 and 2003, respectively: risk-free interest rates of 4.3%, 4.1% and 3.8%; dividend yield of 2.3%, 2.4% and 3.0%; expected lives of 7, 10 and 10 years, respectively; and volatility of 19.4%, 22.0% and 28.3%. Expense is reflected on a straight-line basis over the vesting period. The expense amount for the year ended December 31, 2004 also includes the impact of accelerated vesting of outstanding stock options, as described below.

HMEC's Board of Directors approved the acceleration of vesting of all outstanding stock options effective June 30, 2004. The Board placed certain restrictions on the transfer of shares obtained by this vesting acceleration for members of the Board of Directors and 10 of HMEC's key executive officers. At June 30, 2004, the majority of the options vested were out-of-the-money. The accelerated vesting had an immaterial effect on the Company's operating expenses.

### *Income Taxes*

The Company uses the liability method for calculating deferred federal income taxes. Income tax provisions are generally based on income reported for financial statement purposes. The provisions for federal income taxes for the years ended December 31, 2005, 2004 and 2003 include amounts currently payable and deferred income taxes resulting from the cumulative differences in the Company's assets and liabilities, determined on a tax return versus financial statement basis.

Deferred tax assets and liabilities include provisions for unrealized investment gains and losses as well as the minimum pension liability adjustment with the changes for each period included in the respective components of accumulated other comprehensive income (loss) in shareholders' equity.

## NOTE 1 - Summary of Significant Accounting Policies-(Continued)

### Earnings Per Share

Basic earnings per share is computed based on the weighted average number of common shares outstanding. Diluted earnings per share is computed based on the weighted average number of common shares and common stock equivalents outstanding, to the extent dilutive. The common stock equivalents relate to outstanding common stock options, Director Stock Plan units, Employee Stock Plan units and Incentive Compensation Plan restricted common stock units. In addition, the Company's Senior Convertible Notes are common stock equivalents reflecting the implementation of the Financial Accounting Standards Board's Emerging Issues Task Force ("EITF") consensus on issue 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share". This consensus was effective for reporting periods ending after December 15, 2004. While for comparative purposes the guidance in this consensus has been applied to prior period diluted earnings per share, it had no impact for 2003 as the related contingent conversion features were not dilutive for that period.

The computations of net income per share on both basic and diluted bases, including reconciliations of the numerators and denominators, were as follows:

|  | <u>Year Ended December 31,</u> |                 |                 |
|--|--------------------------------|-----------------|-----------------|
|  | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>     |
| Basic - assumes no dilution:   |                                |                 |                 |
| Net income for the period .....  | <u>\$77,273</u>                | <u>\$56,313</u> | <u>\$18,975</u> |
| Weighted average number of common shares outstanding during the period (in thousands).....   | <u>42,913</u>                  | <u>42,762</u>   | <u>42,713</u>   |
| Net income per share – basic.....  | <u>\$ 1.80</u>                 | <u>\$ 1.32</u>  | <u>\$ 0.44</u>  |
| Diluted - assumes full dilution:   |                                |                 |                 |
| Net income for the period .....  | \$77,273                       | \$56,313        | \$18,975        |
| Interest expense, net of tax, on dilutive Senior Convertible Notes .....   | <u>2,737</u>                   | <u>2,737</u>    | <u>-</u>        |
| Adjusted net income for the period .....   | <u>\$80,010</u>                | <u>\$59,050</u> | <u>\$18,975</u> |
| Weighted average number of common shares outstanding during the period (in thousands) .....  | 42,913                         | 42,762          | 42,713          |
| Weighted average number of common equivalent shares to reflect the dilutive effect of common stock equivalent securities (in thousands): |                                |                 |                 |
| Stock options .....  | 136                            | 58              | 16              |
| Common stock units related to Deferred Equity Compensation Plan for Directors.....   | 192                            | 159             | 148             |
| Common stock units related to Deferred Compensation Plan for Employees .....   | 146                            | 25              | 27              |
| Restricted common stock units related to Incentive Compensation Plan.....  | 155                            | -               | -               |
| Weighted average number of common equivalent shares to reflect the dilutive effect of Senior Convertible Notes (in thousands) .....      | <u>4,343</u>                   | <u>4,343</u>    | <u>-</u>        |
| Total common and common equivalent shares adjusted to calculate diluted earnings per share (in thousands) .....                          | <u>47,885</u>                  | <u>47,347</u>   | <u>42,904</u>   |
| Net income per share – diluted.....  | <u>\$ 1.67</u>                 | <u>\$ 1.25</u>  | <u>\$ 0.44</u>  |

Options to purchase 2,458,700 shares of common stock at \$18.76 to \$33.87 per share were granted in 1997 through 2005 but were not included in the computation of 2005 diluted earnings per share because the options' exercise price was greater than the average market price of the common shares during 2005. The options, which expire in 2007 through 2015, were still outstanding at December 31, 2005.

## NOTE 1 - Summary of Significant Accounting Policies-(Continued)

### Comprehensive Income

Comprehensive income represents the change in shareholders' equity during a reporting period from transactions and other events and circumstances from non-shareholder sources. For the Company, comprehensive income is equal to net income plus the change in net unrealized gains and losses on fixed maturities and equity securities and the change in the minimum pension liability adjustment for the period as shown in the Statement of Changes in Shareholders' Equity.

The components of comprehensive income were as follows:

|   | <u>Year Ended December 31,</u> |                 |                 |
|---|--------------------------------|-----------------|-----------------|
|   | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>     |
| Net income .....  | \$ 77,273                      | \$56,313        | \$18,975        |
| Other comprehensive income:   |                                |                 |                 |
| Change in net unrealized gains on fixed maturities and equity securities                      |                                |                 |                 |
| Unrealized holding gains on fixed maturities and equity securities arising during period..... | (98,199)                       | 18,994          | 27,027          |
| Less: reclassification adjustment for gains included in income before income tax.....         | 9,851                          | 12,434          | 25,425          |
| Total, before tax.....  | (88,348)                       | 6,560           | 1,602           |
| Income tax (benefit) expense.....   | (30,922)                       | 2,296           | 561             |
| Total, net of tax.....  | (57,426)                       | 4,264           | 1,041           |
| Change in minimum pension liability adjustment  |                                |                 |                 |
| Before tax.....   | 1,063                          | 3,477           | 22              |
| Income tax expense .....  | 372                            | 1,217           | 9               |
| Total, net of tax.....  | 691                            | 2,260           | 13              |
| Total comprehensive income .....  | <u>\$ 20,538</u>               | <u>\$62,837</u> | <u>\$20,029</u> |

### Statements of Cash Flows

For purposes of the Consolidated Statements of Cash Flows, cash constitutes cash on deposit at banks.

### Reclassification

The Company has reclassified the presentation of certain prior period information to conform with the 2005 presentation.

## NOTE 2 - Investments

### Net Investment Income

The components of net investment income for the following periods were:

|  | <u>Year Ended December 31,</u> |                  |                  |
|--|--------------------------------|------------------|------------------|
|  | <u>2005</u>                    | <u>2004</u>      | <u>2003</u>      |
| Fixed maturities .....                 | \$191,289                      | \$188,953        | \$181,716        |
| Short-term and other investments ..... | 8,076                          | 6,738            | 7,059            |
| Total investment income.....           | 199,365                        | 195,691          | 188,775          |
| Less investment expenses .....         | 4,733                          | 4,243            | 4,050            |
| Net investment income.....             | <u>\$194,632</u>               | <u>\$191,448</u> | <u>\$184,725</u> |

### Realized Investment Gains (Losses)

Realized investment gains (losses) for the following periods were:

|  | <u>Year Ended December 31,</u> |                 |                 |
|--|--------------------------------|-----------------|-----------------|
|  | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>     |
| Fixed maturities .....                 | \$ 9,851                       | \$12,434        | \$21,753        |
| Short-term and other investments ..... | (10)                           | (237)           | 3,734           |
| Realized investment gains.....         | <u>\$ 9,841</u>                | <u>\$12,197</u> | <u>\$25,487</u> |

### Fixed Maturity Securities ("fixed maturities")

At December 31, 2005 and 2004, the fair value and gross unrealized losses of investments in debt securities were as follows:

|  | <u>Less than 12 months</u> |                          | <u>12 months or longer</u> |                          | <u>Total</u>       |                          |
|--|----------------------------|--------------------------|----------------------------|--------------------------|--------------------|--------------------------|
|  | <u>Fair Value</u>          | <u>Unrealized Losses</u> | <u>Fair Value</u>          | <u>Unrealized Losses</u> | <u>Fair Value</u>  | <u>Unrealized Losses</u> |
| <b>As of December 31, 2005</b>                             |                            |                          |                            |                          |                    |                          |
| U.S. government and federally sponsored agency obligations |                            |                          |                            |                          |                    |                          |
| Mortgage-backed securities.....                            | \$ 442,033                 | \$ 7,968                 | \$148,292                  | \$ 4,864                 | \$ 590,325         | \$12,832                 |
| Other .....  | 185,447                    | 1,312                    | 52,042                     | 1,296                    | 237,489            | 2,608                    |
| Municipal bonds.....                                       | 186,299                    | 1,644                    | 45,164                     | 1,431                    | 231,463            | 3,075                    |
| Foreign government bonds.....                              | 7,337                      | 109                      | 1,836                      | 50                       | 9,173              | 159                      |
| Corporate bonds .....                                      | 735,272                    | 14,581                   | 105,142                    | 3,628                    | 840,414            | 18,209                   |
| Other mortgage-backed securities....                       | 68,214                     | 1,222                    | 41,746                     | 1,216                    | 109,960            | 2,438                    |
| Totals .....   | <u>\$1,624,602</u>         | <u>\$26,836</u>          | <u>\$394,222</u>           | <u>\$12,485</u>          | <u>\$2,018,824</u> | <u>\$39,321</u>          |
| <b>As of December 31, 2004</b>                             |                            |                          |                            |                          |                    |                          |
| U.S. government and federally sponsored agency obligations |                            |                          |                            |                          |                    |                          |
| Mortgage-backed securities.....                            | \$ 143,769                 | \$ 656                   | \$ 59,931                  | \$ 1,502                 | \$ 203,700         | \$ 2,158                 |
| Other .....  | 90,182                     | 540                      | 389                        | 26                       | 90,571             | 566                      |
| Municipal bonds.....                                       | 123,402                    | 1,274                    | 32,005                     | 859                      | 155,407            | 2,133                    |
| Foreign government bonds.....                              | 1,914                      | 1                        | 3,906                      | 116                      | 5,820              | 117                      |
| Corporate bonds .....                                      | 156,940                    | 1,426                    | 20,337                     | 1,116                    | 177,277            | 2,542                    |
| Other mortgage-backed securities....                       | 54,017                     | 895                      | 4,526                      | 385                      | 58,543             | 1,280                    |
| Totals .....   | <u>\$ 570,224</u>          | <u>\$ 4,792</u>          | <u>\$121,094</u>           | <u>\$ 4,004</u>          | <u>\$ 691,318</u>  | <u>\$ 8,796</u>          |

## NOTE 2 - Investments-(Continued)

At December 31, 2005, the gross unrealized loss position in the investment portfolio was \$39,321 (545 positions and 1% of the investment portfolio). Securities with an investment grade rating represented 94% of the unrealized loss. The largest single unrealized loss was \$1,148 on a FNMA mortgage-backed security purchased in June 2003 when interest rates hit 40 year lows. The majority of the unrealized losses were due to changes in interest rates. There was one security trading below 80% of amortized cost with an associated unrealized loss of \$292 compared to amortized cost of \$1,001. The portfolio included 96 securities that have been in an unrealized loss position for greater than 12 months, totaling \$12,486 (of which \$5,155 was from securities purchased in 2003 when interest rates were at record lows). The Company views the decrease in value of all of the securities with unrealized losses at December 31, 2005 as temporary, expects recovery in fair value, anticipates continued payments under the terms of the securities, and has the intent and ability to hold these securities until maturity or a recovery in fair value occurs. Therefore, no impairment of these securities was recorded at December 31, 2005.

The amortized cost, unrealized investment gains and losses, and fair values of fixed maturities as of December 31, 2005 and 2004 were as follows:

|  | <u>Amortized<br/>Cost</u> | <u>Unrealized<br/>Gains</u> | <u>Unrealized<br/>Losses</u> | <u>Fair<br/>Value</u> |
|--|---------------------------|-----------------------------|------------------------------|-----------------------|
| <b>As of December 31, 2005</b>                                 |                           |                             |                              |                       |
| U.S. government and federally sponsored agency obligations (1) |                           |                             |                              |                       |
| Mortgage-backed securities.....                                | \$ 700,057                | \$ 2,938                    | \$12,832                     | \$ 690,163            |
| Other .....  | 273,624                   | 1,225                       | 2,608                        | 272,241               |
| Municipal bonds.....   | 571,172                   | 8,718                       | 3,075                        | 576,815               |
| Foreign government bonds.....                                  | 29,767                    | 1,652                       | 159                          | 31,260                |
| Corporate bonds.....   | 1,942,504                 | 70,411                      | 18,209                       | 1,994,706             |
| Other mortgage-backed securities.....                          | 138,160                   | 2,395                       | 2,438                        | 138,117               |
| Totals .....   | <u>\$3,655,284</u>        | <u>\$ 87,339</u>            | <u>\$39,321</u>              | <u>\$3,703,302</u>    |
| <b>As of December 31, 2004</b>                                 |                           |                             |                              |                       |
| U.S. government and federally sponsored agency obligations (1) |                           |                             |                              |                       |
| Mortgage-backed securities.....                                | \$ 674,109                | \$ 9,853                    | \$ 2,158                     | \$ 681,804            |
| Other .....  | 206,704                   | 2,829                       | 566                          | 208,967               |
| Municipal bonds.....   | 568,165                   | 12,888                      | 2,133                        | 578,920               |
| Foreign government bonds.....                                  | 32,575                    | 3,809                       | 117                          | 36,267                |
| Corporate bonds.....   | 1,821,267                 | 117,867                     | 2,542                        | 1,936,592             |
| Other mortgage-backed securities.....                          | 96,434                    | 3,551                       | 1,280                        | 98,705                |
| Totals .....   | <u>\$3,399,254</u>        | <u>\$150,797</u>            | <u>\$ 8,796</u>              | <u>\$3,541,255</u>    |

(1) Fair value includes securities issued by Federal National Mortgage Association ("FNMA") of \$552,941 and \$550,638; Federal Home Loan Mortgage Association ("FHLMA") of \$203,462 and \$179,838; and Government National Mortgage Association ("GNMA") of \$33,439 and \$26,808 as of December 31, 2005 and 2004, respectively.

The Company's investment portfolio includes no derivative financial instruments (futures, forwards, swaps, option contracts or other financial instruments with similar characteristics).

**NOTE 2 - Investments-(Continued)**

*Maturities/Sales Of Investments*

The amortized cost and fair value of fixed maturities at December 31, 2005, by estimated expected maturity, are shown below. Estimated expected maturities differ from contractual maturities reflecting assumptions regarding borrowers' utilization of the right to call or prepay obligations with or without call or prepayment penalties. Estimated expected maturities consider broker dealer survey values and are verified for consistency with the interest rate and economic environments.

|   | <u>December 31, 2005</u>  |                       |  |
|---|---------------------------|-----------------------|--|
|   | <u>Amortized<br/>Cost</u> | <u>Fair<br/>Value</u> | <u>Percent of<br/>Total Fair<br/>Value</u> |
| Due in 1 year or less.....                | \$ 252,773                | \$ 256,094            | 6.9%                                       |
| Due after 1 year through 5 years .....    | 1,014,324                 | 1,027,649             | 27.8                                       |
| Due after 5 years through 10 years .....  | 1,433,249                 | 1,452,076             | 39.2                                       |
| Due after 10 years through 20 years ..... | 354,494                   | 359,151               | 9.7  |
| Due after 20 years .....                  | <u>600,444</u>            | <u>608,332</u>        | <u>16.4</u>                                |
| Total .....                               | <u>\$3,655,284</u>        | <u>\$3,703,302</u>    | <u>100.0%</u>                              |

The average option adjusted duration for the Company's fixed maturities portfolio was 5.5 years at December 31, 2005.

Proceeds from sales/maturities of fixed maturities and gross gains and gross losses realized for each year were:

|                             | <u>Year Ended December 31,</u> |             |             |
|-----------------------------|--------------------------------|-------------|-------------|
|                             | <u>2005</u>                    | <u>2004</u> | <u>2003</u> |
| Proceeds .....              | \$ 726,290                     | \$1,001,662 | \$1,483,614 |
| Gross gains realized.....   | 20,816                         | 16,893      | 50,907      |
| Gross losses realized ..... | (9,116)                        | (4,459)     | (12,903)    |

*Unrealized Gains (Losses) on Fixed Maturities*

Net unrealized gains are computed as the difference between fair value and amortized cost for fixed maturities. A summary of the net increase in unrealized investment gains on fixed maturities, less applicable income taxes, is as follows:

|   | <u>Year Ended December 31,</u> |                 |                 |
|---|--------------------------------|-----------------|-----------------|
|   | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>     |
| Net unrealized gains on fixed maturities  |                                |                 |                 |
| Beginning of period.....  | \$ 142,001                     | \$ 133,813      | \$ 132,188      |
| End of period .....   | <u>48,018</u>                  | <u>142,001</u>  | <u>133,813</u>  |
| Increase (decrease) for the period.....   | (93,983)                       | 8,188           | 1,625           |
| Income taxes (benefits) .....   | <u>(32,894)</u>                | <u>2,866</u>    | <u>569</u>      |
| Increase (decrease) in net unrealized gains on fixed maturities before the valuation impact on deferred policy acquisition costs and value of acquired insurance in force ..... | <u>\$ (61,089)</u>             | <u>\$ 5,322</u> | <u>\$ 1,056</u> |

## NOTE 2 - Investments-(Continued)

### *Securities Lending*

The Company loans fixed income securities to third parties, primarily major brokerage firms. As of December 31, 2005, fixed maturities with a fair value of \$189,851 were on loan. No securities were on loan at December 31, 2004. Loans of securities are required at all times to be secured by collateral from borrowers at least equal to 100% of the market value of the securities loaned. The Company maintains effective control over the loaned securities and therefore reports them as Fixed Maturity Securities in the Consolidated Balance Sheets. Securities lending collateral is classified as investments with a corresponding liability in the Company's Consolidated Balance Sheets.

### *Investment in Entities Exceeding 10% of Shareholders' Equity*

At December 31, 2005 and 2004, there were no investments which exceeded 10% of total shareholders' equity in entities other than obligations of the U.S. Government and federally sponsored government agencies and authorities.

### *Deposits*

At December 31, 2005, securities with a carrying value of \$16,355 were on deposit with governmental agencies as required by law in various states in which the insurance subsidiaries of HMEC conduct business.

### NOTE 3 - Property and Casualty Unpaid Claims and Claim Expenses

The following table sets forth an analysis of property and casualty unpaid claims and claim expenses and provides a reconciliation of beginning and ending reserves for the periods indicated.

|   | <u>Year Ended December 31,</u> |                  |                  |
|---|--------------------------------|------------------|------------------|
|   | <u>2005</u>                    | <u>2004</u>      | <u>2003</u>      |
| Gross reserves, beginning of year .....   | \$335,000                      | \$304,307        | \$275,706        |
| Less reinsurance recoverables .....   | <u>25,722</u>                  | <u>20,615</u>    | <u>44,701</u>    |
| Net reserves, beginning of year (1) .....   | <u>309,278</u>                 | <u>283,692</u>   | <u>231,005</u>   |
| Incurred claims and claim expenses:   |                                |                  |                  |
| Claims occurring in the current year .....  | 411,122                        | 435,451          | 416,473          |
| Increase (decrease) in estimated reserves for<br>claims occurring in prior years (2): |                                |                  |                  |
| Policies written by the Company .....   | (13,100)                       | 3,815            | 58,270           |
| Business assumed from state reinsurance facilities .....                              | <u>-</u>                       | <u>-</u>         | <u>(1,900)</u>   |
| Total increase (decrease) .....   | <u>(13,100)</u>                | <u>3,815</u>     | <u>56,370</u>    |
| Total claims and claim expenses incurred (3) .....                                    | <u>398,022</u>                 | <u>439,266</u>   | <u>472,843</u>   |
| Claims and claim expense payments<br>for claims occurring during:                     |                                |                  |                  |
| Current year .....  | 252,311                        | 268,520          | 259,748          |
| Prior years .....   | <u>143,932</u>                 | <u>145,160</u>   | <u>160,408</u>   |
| Total claims and claim expense payments .....   | <u>396,243</u>                 | <u>413,680</u>   | <u>420,156</u>   |
| Net reserves, end of year (1) .....   | 311,057                        | 309,278          | 283,692          |
| Plus reinsurance recoverables .....   | <u>31,604</u>                  | <u>25,722</u>    | <u>20,615</u>    |
| Gross reserves, end of year (4) .....   | <u>\$342,661</u>               | <u>\$335,000</u> | <u>\$304,307</u> |

- (1) Reserves net of anticipated reinsurance recoverables.
- (2) Shows the amounts by which the Company increased or decreased its reserves in each of the periods indicated for claims occurring in previous periods to reflect subsequent information on such claims and changes in their projected final settlement costs. Also refer to the paragraphs below for additional information regarding the reserve development recorded in 2005, 2004 and 2003.
- (3) Benefits, claims and settlement expenses as reported in the Consolidated Statements of Operations also include life, annuity, group accident and health and corporate amounts of \$44,695, \$45,144 and \$46,135 for the years ended December 31, 2005, 2004 and 2003, respectively, in addition to the property and casualty amounts.
- (4) Unpaid claims and claim expenses as reported in the Consolidated Balance Sheets also include life, annuity, and group accident and health reserves of \$8,100, \$7,445 and \$9,005 at December 31, 2005, 2004 and 2003, respectively, in addition to property and casualty reserves.

Underwriting results of the property and casualty segment are significantly influenced by estimates of the Company's ultimate liability for insured events. There is a high degree of uncertainty inherent in the estimates of ultimate losses underlying the liability for unpaid claims and claim expenses. This inherent uncertainty is particularly significant for liability-related exposures due to the extended period, often many years, that transpires between a loss event, receipt of related claims data from policyholders and ultimate settlement of the claim. Reserves for property and casualty claims include provisions for payments to be made on reported claims, claims incurred but not yet reported ("IBNR") and associated settlement expenses. The process by which these reserves are established requires reliance upon estimates based on known facts and on interpretations of circumstances, including the Company's experience with similar cases and historical trends involving claim payments and related patterns, pending levels of unpaid claims and product mix, as well as other factors including court decisions, economic conditions and public attitudes.

### **NOTE 3 - Property and Casualty Unpaid Claims and Claim Expenses-(Continued)**

The Company continually updates loss estimates using both quantitative and qualitative information from its reserving actuaries and information derived from other sources. Adjustments may be required as information develops which varies from experience, or, in some cases, augments data which previously were not considered sufficient for use in determining liabilities. The effects of these adjustments may be significant and are charged or credited to income for the period in which the adjustments are made.

Net favorable development of total reserves for property and casualty claims occurring in prior years was \$13,100 in 2005 reflecting favorable loss emergence trends in both the voluntary automobile and property lines of business. Net adverse development of total reserves for property and casualty claims occurring in prior years was \$3,815 in 2004 reflecting additional information related to a single liability claim that occurred over 15 years ago. Excluding involuntary business, net adverse development of reserves for property and casualty claims occurring in prior years was \$58,270 for the full year 2003, primarily related to automobile liability loss reserves from the 2001 and 2002 accident years. Net adverse development of total reserves for property and casualty claims occurring in prior years, including involuntary business, was \$3,815 in 2004 and \$56,370 in 2003.

The Company completes a detailed study of property and casualty reserves based on information available at the end of each quarter and year. Trends of reported losses (paid amounts and case reserves on claims reported to the Company) for each accident year are reviewed and ultimate loss costs for those accident years are estimated. For 2001 through 2005, the Company engaged an independent property and casualty actuarial consulting firm to prepare an independent study of the Company's property and casualty reserves at June 30 and December 31 of each year. Beginning in 2006, the independent actuarial consulting firm will prepare an independent study of reserves at December 31, supplemented by other analyses throughout the year.

Based on an assessment of the relative weight given to emerging trends resulting from recent business process changes, pricing, underwriting and claims handling, at both December 31, 2004 and 2005 the Company recorded property and casualty reserves toward the higher end of a reasonable range of reserve estimates, due primarily to reserves related to the automobile liability coverages.

The Company's December 31, 2003 actuarial analysis and reserve estimates incorporated the observations of the independent consultant's claims and reserving practices review (see additional discussion below). In recording the December 31, 2003 property and casualty reserves, the Company assessed the relative weight given to emerging claim trends resulting from recent business process changes, pricing and claims handling. Based upon this analysis, the Company selected a point modestly above the midpoint of a reasonable range, due primarily to reserves related to the automobile liability coverages.

### **NOTE 3 - Property and Casualty Unpaid Claims and Claim Expenses-(Continued)**

During 2002 and 2003, the Company made changes in its property and casualty claims function including hiring of new management and claim adjusters, implementing improved processes, and consolidating the previous 17 branch offices into 6 regional claims offices, which began in late-November 2002 and was completed in the first quarter of 2003. Installation and implementation of the new claims administration system, including related process changes, occurred in the third and fourth quarters of 2003 in the first two claims offices with the remaining four offices completed in the first half of 2004.

As part of the claims operation redesign effort, open claim files -- particularly for automobile liability claims -- were reviewed by the new team. In the first half of 2003, these reassessments resulted in a higher projected ultimate liability for automobile liability claims from accident years 2001, 2000 and 1999 and prior. The high level of property and casualty paid and case reserve activity on older bodily injury claims that was observed in the second quarter of 2003 continued in the third quarter as the Company's new claims organization intensified their efforts to bring older claims files up to date. Furthermore, the acceleration of claim disposition rates extended into the third quarter of 2003, as the new organization also moved to reduce the backlog of older claims and handle current claims on a more timely basis. As a result, the estimation of claims costs, settlement rates and severity was complicated during 2002 and 2003 due to the degree of change involved.

As a result of the factors above, and in light of the pattern of adverse prior years' reserve development observed over the five quarters ended September 30, 2003, at the end of the third quarter, the Company's management retained an independent property and casualty actuarial and claims consulting firm to conduct a detailed review of the Company's claims handling practices and their integration with the Company's reserving practices. The consultant's claims and actuarial specialists reviewed claim files as well as past and new claims handling processes and procedures, including case reserving practices, in each of the Company's six claims offices. They also performed an assessment of the Company's actuarial processes for establishing IBNR and supplemental reserves.

In the third quarter of 2002, the Company increased its reserves for prior accident years primarily related to allocated claim adjustment expenses for the voluntary automobile and homeowners lines and claims for the educator excess professional liability product. The Company had noted increases in paid claims and claim expenses for prior accident years in these lines during the first and second quarters of 2002 and continued to monitor such adverse trends until such time as the Company believed that they were sufficiently credible to require adjustment of the reserves. As a result, the Company revised its loss projections in the third quarter of 2002, incorporating the higher paid claims and claim expense trends.

In the fourth quarter of 2002, the Company increased its reserves for prior accident years related primarily to (1) automobile claim reserves from accident years 2001, 2000 and years prior to 1997 and (2) allocated and unallocated claim expense reserves from the 2001 accident year for both automobile and homeowners. During the third and fourth quarters of 2002, the Company continued to closely monitor emerging trends in (1) the severity of payments on previously reported losses for voluntary automobile and (2) paid claims adjustment expenses for these prior accident years until such time as the Company believed that the trends were sufficiently credible to require adjustment of the reserves. As a result, the Company revised its projections in the fourth quarter of 2002, incorporating the higher paid claims and claim expense trends.

### NOTE 3 - Property and Casualty Unpaid Claims and Claim Expenses-(Continued)

At the time each of the reserve analyses were performed, the Company believed that each estimate was based upon sound and correct methodology and such methodology was appropriately applied and that there were no trends which indicated the likelihood of future adverse development. The financial impact of the net reserve strengthening was therefore accounted for in the period that the change was determined.

No other unusual adjustments were made in the determination of the liabilities during the periods covered by these consolidated financial statements. Management believes that, based on data currently available, it has reasonably estimated the Company's ultimate losses.

### NOTE 4 - Debt

Indebtedness and scheduled maturities at December 31, 2005 and 2004 consisted of the following:

|   | Effective<br>Interest<br>Rates | Final<br>Maturity | December 31,     |                  |
|---|--------------------------------|-------------------|------------------|------------------|
|   |                                |                   | 2005             | 2004             |
| Short-term debt:  |                                |                   |                  |                  |
| Bank Credit Facility .....  | Variable                       | 2009              | \$ -             | \$ 25,000        |
| Long-term debt:   |                                |                   |                  |                  |
| 1.425% Senior Convertible Notes, Face amount of<br>\$244,500 less unaccrued discount of \$128,362 ..... | 3.0%                           | 2032              | 116,138          | 116,138          |
| 6.05% Senior Notes, Face amount of \$75,000 less<br>unaccrued discount of \$252 .....                   | 6.1%                           | 2015              | 74,748           | -                |
| 6 5/8% Senior Notes, Face amount of \$28,600 less<br>unaccrued discount of \$18 .....                   | 6.7%                           | 2006              | -                | 28,582           |
| Total .....   |                                |                   | <u>\$190,886</u> | <u>\$169,720</u> |

#### *Credit Agreement with Financial Institutions ("Bank Credit Facility")*

On May 31, 2005, HMEC entered into a new Bank Credit Agreement which provides for unsecured borrowings of up to \$100,000 (the "Current Bank Credit Facility"). The Current Bank Credit Facility expires on May 30, 2009. Interest accrues at varying spreads relative to corporate or Eurodollar base rates and is payable monthly or quarterly depending on the applicable base rate. The unused portion of the Current Bank Credit Facility is subject to a variable commitment fee, which was 0.175% on an annual basis at December 31, 2005. On May 31, 2005, the Company borrowed \$25,000 and subsequently repaid this balance in full on June 13, 2005, utilizing a portion of the proceeds from the issuance of the Senior Notes due 2015, described below.

On May 29, 2002, HMEC entered into a Bank Credit Agreement that was amended effective June 1, 2004, increasing the commitment amount to \$35,000, and May 3, 2005, extending the commitment termination date to June 30, 2005 from the previous termination date of May 31, 2005 (the "Previous Bank Credit Agreement"). The Previous Bank Credit Agreement was terminated on May 31, 2005, when the Company entered into the Current Bank Credit Facility. The \$25,000 balance outstanding under the Previous Bank Credit Agreement was repaid in full on May 31, 2005, utilizing the borrowing under the Current Bank Credit Facility, described above.

## NOTE 4 - Debt-(Continued)

### *1.425% Senior Convertible Notes ("Senior Convertible Notes")*

On May 14, 2002, the Company issued \$353,500 aggregate principal amount of 1.425% senior convertible notes due in 2032 at a discount of 52.5% resulting in an effective yield of 3.0%. In 2002, the Company repurchased \$53,000 aggregate principal amount, \$25,175 carrying value, of the outstanding Senior Convertible Notes at an aggregate cost of \$22,770. In addition to these cash transactions, in December 2002 the Company repurchased an additional \$56,000 aggregate principal amount, \$26,600 carrying value, of the outstanding Senior Convertible Notes at an aggregate cost of \$25,984 in a non-cash transaction. As consideration for this repurchase, 1,837,925 shares of HMEC's common stock were issued. As of December 31, 2005, HMEC held \$56,000 aggregate principal amount of its Senior Convertible Notes in a brokerage account which could be reissued by the Company.

Interest on the Senior Convertible Notes is payable semi-annually at a rate of 1.425% beginning November 14, 2002 until May 14, 2007. After that date, cash interest will not be paid on the Senior Convertible Notes prior to maturity unless contingent cash interest becomes payable. From May 15, 2007 through maturity of the Senior Convertible Notes, interest will be recognized at the effective rate of 3.0% and will represent the accrual of discount, excluding any contingent cash interest that may become payable. Contingent cash interest becomes payable if the average market price of a Senior Convertible Note for a five trading day measurement period preceding the applicable six-month period equals 120% or more of the sum of the Senior Convertible Note's issue price, accrued original issue discount and accrued cash interest, if any, for such Senior Convertible Note. The contingent cash interest payable per Senior Convertible Note with respect to any quarterly period within any six-month period will equal the then applicable conversion rate multiplied by the greater of (i) \$0.105 or (ii) any regular cash dividends paid by the Company per share on HMEC's common stock during that quarterly period.

The Senior Convertible Notes will be convertible at the option of the holders into shares of HMEC's common stock at a conversion price of \$26.74 if the conditions for conversion are satisfied. The Senior Convertible Notes are potentially convertible into 4,343,054 shares (17.763 shares per \$1 thousand face amount) and with the implementation of EITF Consensus No. 04-8 these shares are included in the calculation of diluted earnings per share to the extent dilutive. The Company may elect to pay holders surrendering notes cash or a combination of cash and shares of HMEC's common stock for the notes surrendered. Holders may also surrender Senior Convertible Notes for conversion during any period in which the credit rating assigned to the Senior Convertible Notes is Ba2 or lower by Moody's or BB+ or lower by S&P, the Senior Convertible Notes are no longer rated by either Moody's or S&P, or the credit rating assigned to the Senior Convertible Notes has been suspended or withdrawn by either Moody's or S&P. The Senior Convertible Notes will cease to be convertible pursuant to this credit rating criteria during any period or periods in which all of the credit ratings are increased above such levels. The Senior Convertible Notes are redeemable by HMEC in whole or in part, at any time on or after May 14, 2007, at redemption prices equal to the sum of the issue price plus accrued original issue discount and accrued cash interest, if any, on the applicable redemption date. The holders of the Senior Convertible Notes may require HMEC to purchase all or a portion of their Senior Convertible Notes on either May 14, 2007, 2012, 2017, 2022, or 2027 at stated prices plus accrued cash interest, if any, to the purchase date. HMEC may pay the purchase price in cash or shares of HMEC common stock or in a combination of cash and shares of HMEC common stock.

## **NOTE 4 - Debt-(Continued)**

### *6.05% Senior Notes due 2015 ("Senior Notes due 2015")*

On June 9, 2005, the Company issued \$75,000 face amount of senior notes at an effective yield of 6.1%, which will mature on June 15, 2015. Interest on the Senior Notes due 2015 is payable semi-annually at a rate of 6.05%. The Senior Notes due 2015 are redeemable in whole or in part, at any time, at the Company's option, at a redemption price equal to the greater of (1) 100% of their principal amount or (2) the sum of the present values of the remaining scheduled payments of principal and interest thereon discounted, on a semi-annual basis, at the Treasury yield (as defined in the indenture) plus 30 basis points, plus, in either of the above cases, accrued interest to the date of redemption.

The net proceeds from the sale of the Senior Notes due 2015 were used to (1) repay the Current Bank Credit Facility, (2) redeem the Senior Notes due 2006, described below, and (3) make a capital contribution to HMEC's primary life insurance subsidiary to substantially offset the early recapture of the Company's life reinsurance agreement with the United States branch of Sun Life Assurance Company of Canada.

### *6 5/8% Senior Notes due 2006 ("Senior Notes due 2006")*

On June 30, 2005, the Company redeemed all of its outstanding Senior Notes due 2006, \$28,600 aggregate principal amount, utilizing a portion of the proceeds from the issuance of the Senior Notes due 2015, described above. The aggregate cost of the repurchase was \$29,107.

### *Universal Shelf Registration*

To provide additional capital management flexibility, the Company filed a "universal shelf" registration on Form S-3 with the SEC in December 2003. The registration statement, which registers the offer and sale by the Company from time to time of up to \$300,000 of various securities, which may include debt securities, preferred stock, common stock and/or depository shares, was declared effective on December 30, 2003. The \$75,000 face amount of Senior Notes due 2015 was issued utilizing this registration statement. No other securities associated with the registration statement have been issued as of the date of this Report on Form 10-K.

### *Debt Retirement Charges*

The repurchase of the Senior Notes due 2006 resulted in a pretax charge to income for the year December 31, 2005 of \$507, which was reported as a component of interest expense in the third quarter.

### *Covenants*

The Company is in compliance with all of the financial covenants contained in the Senior Convertible Notes indenture, the Senior Notes due 2015 indenture and the Bank Credit Facility Agreement, consisting primarily of relationships of (1) debt to capital, (2) insurance subsidiaries' insurance financial strength ratings issued by A.M. Best Company, Inc. and (3) net worth, as defined in the financial covenants.

## **NOTE 5 - Shareholders' Equity and Stock Options**

### *Share Repurchase Program and Treasury Shares Held (Common Stock)*

At December 31, 2005, the Company held 17,503,371 shares in treasury. As of December 31, 2005, \$96,343 remained authorized for future share repurchases.

### *Authorization of Preferred Stock*

In 1996, the shareholders of HMEC approved authorization of 1,000,000 shares of \$0.001 par value preferred stock. The Board of Directors is authorized to (1) direct the issuance of the preferred stock in one or more series, (2) fix the dividend rate, conversion or exchange rights, redemption price and liquidation preference, of any series of the preferred stock, (3) fix the number of shares for any series and (4) increase or decrease the number of shares of any series. No shares of preferred stock were outstanding at December 31, 2005, 2004 and 2003.

Through May 7, 2005, the Company's catastrophe reinsurance program was augmented by a \$75,000 equity put and reinsurance agreement. The equity put provided an option to sell shares of the Company's convertible preferred stock with a floating rate dividend at a pre-negotiated price in the event losses from catastrophes exceeded the catastrophe reinsurance program coverage limit. Before tax benefits, the equity put provided a source of capital for up to \$115,000 of catastrophe losses above the reinsurance coverage limit. The agreement contained certain conditions to Horace Mann's exercise of the equity put option. Fees related to this equity put option were charged directly to additional paid-in capital.

In connection with the equity put described in the preceding paragraph, the Board of Directors has designated a series of preferred stock. The Series so designated is Series A Cumulative Convertible Preferred Stock (the "Series A Stock") and 100,000 shares have been assigned to this series. None of these shares are currently issued or outstanding. The Series A Stock is dividend paying, at a floating rate which varies with movements in the London Interbank Offered Rate and with changes in the risk rating of the Series A Stock as determined by Standard & Poor's Corporation. The Series A Stock does not require any sinking fund or similar mechanism regarding payment of such dividends. Beginning on the fourth anniversary of the issuance of Series A Stock, the holders thereof have the right to demand conversion of the Series A Stock into common stock of the Company at a conversion rate based on then prevailing market prices for the common stock; however, upon receipt of a conversion demand, the Company has the right to redeem the Series A Stock prior to such conversion. The Series A Stock has liquidation rights which place the Series A Stock ahead of the common stock in priority. The Series A Stock has no voting rights other than the requirement that the Series A Stock approve any changes in the Series A Stock, the creation of any other class of stock on a par with or superior to the Series A Stock and certain extraordinary transactions such as certain mergers involving the Company.

## **NOTE 5 - Shareholders' Equity and Stock Options-(Continued)**

### *Director Stock Plan*

In 1996, the shareholders of HMEC approved the Deferred Equity Compensation Plan ("Director Stock Plan") for directors of the Company and reserved 600,000 shares for issuance pursuant to the Director Stock Plan. Shares of the Company's common stock issued under the Director Stock Plan may be either authorized and unissued shares or shares that have been reacquired by the Company. As of December 31, 2005, 2004 and 2003, 191,521, 159,005 and 147,529 units, respectively, were outstanding under this plan representing an equal number of common shares to be issued in the future.

### *Employee Stock Plan*

In 1997, the Board of Directors of HMEC approved the Deferred Compensation Plan for Employees ("Employee Stock Plan"). Shares of the Company's common stock issued under the Employee Stock Plan may be either authorized and unissued shares or shares that have been reacquired by the Company. As of December 31, 2005, 2004 and 2003, 146,218, 25,310 and 27,231 units, respectively, were outstanding under this plan representing an equal number of common shares to be issued in the future.

### *Stock Options and Restricted Common Stock Units*

The shareholders of HMEC approved the 1991 Stock Incentive Plan (the "1991 Plan"), the 2001 Stock Incentive Plan (the "2001 Plan") and the 2002 Incentive Compensation Plan and the Amended and Restated 2002 Incentive Compensation Plan (together, the "2002 Plan") and reserved a total of 9,000,000 shares of common stock for issuance under these plans. Under the 1991 Plan, the 2001 Plan and the 2002 Plan, options to purchase shares of HMEC common stock may be granted to executive officers, other employees and directors. The options are exercisable in installments generally beginning in the first year from the date of grant and generally expiring 7 to 10 years from the date of grant.

Beginning in 2005, restricted common stock units were issued under the 2002 Plan. As of December 31, 2005, 190,157 units were outstanding representing an equal number of common shares to be issued in the future.

## NOTE 5 - Shareholders' Equity and Stock Options-(Continued)

Changes in outstanding options and shares available for grant under the 1991 Plan, the 2001 Plan and the 2002 Plan were as follows:

|                            | Weighted Average<br>Option Price<br>per Share | Range of<br>Option Prices<br>per Share | Options          |                           |                        |
|----------------------------|---|--|------------------|---------------------------|------------------------|
|                            |   |  | Outstanding      | Vested and<br>Exercisable | Available<br>for Grant |
| At December 31, 2002 ..... | \$19.66                                       | \$11.12-\$33.87                        | <u>4,549,420</u> | <u>1,953,564</u>          | <u>2,179,732</u>       |
| Granted.....               | \$13.95                                       | \$13.88-\$15.33                        | 593,700          | 153,841                   | (593,700)              |
| Vested .....               | \$18.80                                       | \$14.78-\$33.87                        | -                | 852,582                   | -                      |
| Expired .....              | \$15.15                                       | \$15.15                                | (96,750)         | (96,750)                  | 96,750                 |
| Forfeited .....            | \$20.51                                       | \$13.88-\$33.87                        | <u>(376,400)</u> | <u>(376,400)</u>          | <u>376,400</u>         |
| At December 31, 2003 ..... | \$18.96                                       | \$11.12-\$33.87                        | <u>4,669,970</u> | <u>2,486,837</u>          | <u>2,059,182</u>       |
| Granted.....               | \$17.32                                       | \$15.28-\$18.86                        | 28,600           | 6,350                     | (28,600)               |
| Vested .....               | \$18.35                                       | \$13.88-\$21.77                        | -                | 2,190,383                 | -                      |
| Exercised.....             | \$14.02                                       | \$11.12-\$17.56                        | (104,192)        | (104,192)                 | -                      |
| Forfeited .....            | \$19.72                                       | \$13.88-\$33.87                        | <u>(375,224)</u> | <u>(375,224)</u>          | <u>375,224</u>         |
| At December 31, 2004 ..... | \$19.01                                       | \$13.88-\$33.87                        | <u>4,219,154</u> | <u>4,204,154</u>          | <u>2,405,806</u>       |
| Granted.....               | \$18.77                                       | \$17.00-\$19.04                        | 555,750          | 11,000                    | (555,750)              |
| Vested .....               | \$18.58                                       | \$16.96-\$18.86                        | -                | 20,650                    | -                      |
| Exercised.....             | \$15.04                                       | \$13.88-\$18.86                        | (124,624)        | (124,624)                 | -                      |
| Forfeited .....            | \$20.37                                       | \$13.88-\$33.87                        | <u>(121,230)</u> | <u>(121,230)</u>          | <u>121,230</u>         |
| At December 31, 2005 ..... | \$19.05                                       | \$13.88-\$33.87                        | <u>4,529,050</u> | <u>3,989,950</u>          | <u>1,971,286 *</u>     |

\* Common stock shares issuable for the 190,157 restricted common stock units awarded in 2005 and outstanding at December 31, 2005 would also draw on this available for grant balance. The Company's stock options and restricted common stock units are subject to a common pool of authorized shares.

The weighted average grant date fair values were \$3.75, \$4.35 and \$3.98 for options granted in 2005, 2004 and 2003, respectively. The weighted average prices of vested and exercisable options as of December 31, 2004 and 2003 were \$19.01 and \$19.49, respectively. For options outstanding at December 31, 2005, information segregated by ranges of exercise prices was as follows:

|                      | Weighted<br>Average<br>Option Price<br>per Share | Range of<br>Option Prices<br>per Share | Total<br>Options<br>Outstanding | Vested and Exercisable Options |  |                             |
|----------------------|--|--|---------------------------------|--------------------------------|--|-----------------------------|
|                      |  |  |                                 | Options                        | Weighted<br>Average<br>Option Price<br>per Share | Weighted<br>Average<br>Life |
| At December 31, 2005 | \$18.35  | \$13.88-\$20.80                        | 4,102,300                       | 3,563,200                      | \$18.29  | 5.5 years                   |
|                      | \$22.77  | \$21.64-\$29.21                        | 311,050                         | 311,050                        | \$22.77  | 4.0 years                   |
|                      | \$33.87  | \$33.87                                | <u>115,700</u>                  | <u>115,700</u>                 | \$33.87  | 2.3 years                   |
| Total.....           | \$19.05  | \$13.88-\$33.87                        | <u>4,529,050</u>                | <u>3,989,950</u>               | \$19.09  | 5.3 years                   |

## NOTE 6 - Income Taxes

The federal income tax assets and liabilities included in Other Assets and Other Liabilities, respectively, in the Consolidated Balance Sheets as of December 31, 2005 and 2004 were as follows:

|                                      | <u>December 31,</u> |             |
|--------------------------------------|---------------------|-------------|
|                                      | <u>2005</u>         | <u>2004</u> |
| Federal income tax (asset) liability |                     |             |
| Current .....                        | \$(17,059)          | \$ (1,761)  |
| Deferred .....                       | 28,316              | 25,882      |

Deferred tax assets and liabilities are recognized for all future tax consequences attributable to "temporary differences" between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. There are no deferred tax liabilities that have not been recognized. The "temporary differences" that give rise to the deferred tax balances at December 31, 2005 and 2004 were as follows:

|  | <u>December 31,</u> |                  |
|--|---------------------|------------------|
|  | <u>2005</u>         | <u>2004</u>      |
| Deferred tax assets  |                     |                  |
| Discounting of unpaid claims and claim expenses tax reserves ..... | \$ 9,443            | \$ 9,830         |
| Life insurance future policy benefit reserve revaluation .....     | 5,155               | 25,786           |
| Unearned premium reserve reduction .....                           | 13,545              | 13,730           |
| Postretirement benefits other than pension .....                   | 10,007              | 10,193           |
| Unutilized net operating loss carryforward .....                   | 13,749              | 19,829           |
| Alternative minimum tax credit carryforward .....                  | 2,611               | -                |
| Unutilized capital loss carryforward .....                         | 1,354               | 4,519            |
| Impaired securities .....  | 1,625               | 2,119            |
| Other comprehensive income – minimum pension liability .....       | 7,700               | 8,073            |
| Compensation accruals .....  | 4,667               | 4,482            |
| Total gross deferred tax assets .....                              | <u>69,856</u>       | <u>98,561</u>    |
| Deferred tax liabilities   |                     |                  |
| Other comprehensive income – unrealized gains on securities .....  | 16,834              | 49,897           |
| Intangible assets .....  | 8,555               | 10,020           |
| Deferred policy acquisition costs .....                            | 70,796              | 62,407           |
| Other, net .....   | 1,987               | 2,119            |
| Total gross deferred tax liabilities .....                         | <u>98,172</u>       | <u>124,443</u>   |
| Net deferred tax liability .....                                   | <u>\$ 28,316</u>    | <u>\$ 25,882</u> |

Based on the Company's historical earnings, future expectations of adjusted taxable income, as well as reversing gross deferred tax liabilities, the Company believes it is more likely than not that gross deferred tax assets will be fully realized and that a valuation allowance with respect to the realization of the total gross deferred tax assets is not necessary.

At December 31, 2005, the Company had available the following loss carryforwards and credits:

| <u>Type</u>                                 | <u>Amount</u> | <u>Expiration Year(s)</u> |
|---|---------------|---------------------------|
| Operating loss carryforwards (pretax) ..... | \$ 39,284     | 2023-2024                 |
| Capital loss carryforwards (pretax) .....   | 3,870         | 2007-2010                 |
| Alternative minimum tax credits .....       | 2,611         | None                      |

**NOTE 6 - Income Taxes-(Continued)**

The components of federal income tax expense (benefit) were as follows:

|                         | Year Ended December 31, |                 |                |
|-------------------------|-------------------------|-----------------|----------------|
|                         | 2005                    | 2004            | 2003           |
| Current .....           | \$(16,212)              | \$ (500)        | \$ 7,106       |
| Deferred .....          | <u>32,983</u>           | <u>13,944</u>   | <u>(6,902)</u> |
| Total tax expense ..... | <u>\$ 16,771</u>        | <u>\$13,444</u> | <u>\$ 204</u>  |

Income tax expense for the following periods differed from the expected tax computed by applying the federal corporate tax rate of 35% to income before income taxes as follows:

|   | Year Ended December 31, |                 |               |
|---|-------------------------|-----------------|---------------|
|   | 2005                    | 2004            | 2003          |
| Expected federal tax on income .....          | \$ 32,916               | \$24,415        | \$ 6,713      |
| Add (deduct) tax effects of:                  |                         |                 |               |
| Tax-exempt interest.....                      | (6,258)                 | (6,214)         | (5,027)       |
| Dividend received deduction .....             | (1,275)                 | (1,667)         | (1,918)       |
| Resolution of contingent tax liabilities..... | (9,176)                 | -               | -             |
| Other, net .....                              | <u>564</u>              | <u>(3,090)</u>  | <u>436</u>    |
| Income tax expense provided on income .....   | <u>\$ 16,771</u>        | <u>\$13,444</u> | <u>\$ 204</u> |

The Company records contingent tax liabilities for exposures from uncertain tax filing positions based upon management's assessment of the amounts that are probable of being sustained upon Internal Revenue Service audit. These liabilities are reevaluated routinely and are adjusted appropriately, based upon changes in facts or law. The Company has no unrecorded contingent tax exposures.

At December 31, 2005, the Company had federal income tax returns for the 2002 through 2004 tax years still open and subject to adjustment upon IRS examination. The Company has recorded \$3,405 of contingent tax liabilities related to those open tax years.

In 2005, the Company recorded reductions in federal income tax expense of \$9,176 due to favorable resolution of contingent tax liabilities (\$5,567 in the corporate and other segment and \$3,609 in the annuity segment) and recorded \$1,394 of pretax income representing interest on federal income tax refunds received (\$937 in the annuity segment and \$457 in the other segments). In April 2005, the Company received refunds for tax years 1996 through 2001 from the IRS totaling \$8,087, an amount consistent with the Company's tax refund accruals related to those years. As a result of the receipt of IRS refunds for tax years 1996 and 1997, which were then deemed to be closed, the contingent tax liability related to those two years was eliminated, which resulted in a decrease in federal income tax expense of \$2,734 in the second quarter of 2005. The remaining refunds received related to tax years 1998 through 2001, which were deemed to be closed on September 15, 2005, resulting in an additional reduction in the contingent tax liability related to those four years of \$6,442 that was recorded in the third quarter of 2005.

## NOTE 7 - Fair Value of Financial Instruments

The Company is required under GAAP to disclose estimated fair values for certain financial instruments. Fair values of the Company's insurance contracts other than annuity contracts are not required to be disclosed. However, the fair values of liabilities under all insurance contracts are taken into consideration in the Company's overall management of interest rate risk through the matching of investment maturities with amounts due under insurance contracts. The following methods and assumptions were used to estimate the fair value of financial instruments.

*Investments* - For fixed maturities and short-term and other investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities, adjusted for differences between the quoted securities and the securities being valued. The fair value of policy loans is based on estimates using discounted cash flow analysis and current interest rates being offered for new loans. The fair value of mortgage loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and the same remaining maturities. The carrying value of real estate is an estimate of fair value based on discounted cash flows from operations.

## NOTE 7 - Fair Value of Financial Instruments-(Continued)

*Annuity Contract Liabilities and Policyholder Account Balances on Interest-sensitive Life Contracts* - The fair values of annuity contract liabilities and policyholder account balances on interest-sensitive life contracts are equal to the discounted estimated future cash flows (using the Company's current interest rates for similar products including consideration of minimum guaranteed interest rates) including an adjustment for risk that the timing or amount of cash flows will vary from management's estimate.

*Other Policyholder Funds* - Other policyholder funds are liabilities related to supplementary contracts without life contingencies and dividend accumulations which represent deposits that do not have defined maturities. The carrying value of these funds is used as a reasonable estimate of fair value.

*Long-term Debt* - The fair value of long-term debt is estimated based on quoted market prices of publicly traded issues.

The carrying amounts and fair values of financial instruments at December 31, 2005 and 2004 consisted of the following:

|  | December 31,               |                       |                            |                       |
|--|----------------------------|-----------------------|----------------------------|-----------------------|
|  | 2005                       |                       | 2004                       |                       |
|  | <u>Carrying<br/>Amount</u> | <u>Fair<br/>Value</u> | <u>Carrying<br/>Amount</u> | <u>Fair<br/>Value</u> |
| <b>Financial Assets</b>  |                            |                       |                            |                       |
| Investments  |                            |                       |                            |                       |
| Fixed maturities .....   | \$3,703,302                | \$3,703,302           | \$3,541,255                | \$3,541,255           |
| Short-term and other investments.....                                      | 100,195                    | 103,739               | 115,835                    | 118,969               |
| Short-term investments,<br>loaned securities collateral.....               | <u>192,995</u>             | <u>192,995</u>        | <u>142</u>                 | <u>142</u>            |
| Total investments .....  | 3,996,492                  | 4,000,036             | 3,657,232                  | 3,660,366             |
| <b>Financial Liabilities</b>   |                            |                       |                            |                       |
| Policyholder account balances on<br>interest-sensitive life contracts..... | 84,089                     | 78,535                | 85,594                     | 83,685                |
| Annuity contract liabilities .....   | 1,818,997                  | 1,649,439             | 1,688,075                  | 1,529,588             |
| Other policyholder funds .....   | 146,078                    | 146,078               | 142,634                    | 142,634               |
| Short-term debt .....  | -                          | -                     | 25,000                     | 25,000                |
| Long-term debt.....  | 190,886                    | 185,714               | 144,720                    | 143,746               |

Fair value assumptions are based upon subjective estimates of market conditions and perceived risks of financial instruments at a certain point in time. The disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial instrument. In addition, potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in amounts disclosed.

## NOTE 8 - Statutory Surplus and Subsidiary Dividend Restrictions

The insurance departments of various states in which the insurance subsidiaries of HMEC are domiciled recognize as net income and surplus those amounts determined in conformity with statutory accounting principles prescribed or permitted by the insurance departments, which differ in certain respects from GAAP.

Reconciliations of statutory capital and surplus and net income, as determined using statutory accounting principles, to the amounts included in the accompanying consolidated financial statements are as follows:

|   | (Unaudited)<br>December 31, |                   |
|---|-----------------------------|-------------------|
|   | <u>2005</u>                 | <u>2004</u>       |
| Statutory capital and surplus of insurance subsidiaries .....                   | \$ 500,256                  | \$470,417         |
| Increase (decrease) due to:   |                             |                   |
| Deferred policy acquisition costs .....   | 233,630                     | 209,576           |
| Difference in policyholder reserves .....                                       | 30,259                      | (28,289)          |
| Goodwill .....  | 47,396                      | 47,396            |
| Value of acquired insurance in force .....                                      | 16,322                      | 21,522            |
| Liability for postretirement benefits, other than pensions .....                | (28,014)                    | (28,917)          |
| Investment fair value adjustments on fixed maturities .....                     | 48,017                      | 142,001           |
| Difference in investment reserves .....   | 43,475                      | 36,555            |
| Federal income tax liability .....  | (63,093)                    | (60,035)          |
| Minimum pension liability adjustment .....                                      | (22,001)                    | (23,065)          |
| Non-admitted assets and other, net .....  | 1,179                       | 1,209             |
| Shareholders' deficit of parent company and<br>non-insurance subsidiaries ..... | (35,949)                    | (42,444)          |
| Parent company short-term and long-term debt .....                              | (190,886)                   | (169,720)         |
| Shareholders' equity as reported herein .....                                   | <u>\$ 580,591</u>           | <u>\$ 576,206</u> |

|   | (Unaudited)<br>Year Ended December 31, |                  |                  |
|---|--|------------------|------------------|
|   | <u>2005</u>                            | <u>2004</u>      | <u>2003</u>      |
| Statutory net income (loss) of insurance subsidiaries .....                               | \$ 76,852                              | \$ 55,617        | \$ 12,616        |
| Net loss of non-insurance companies .....   | (1,662)                                | (2,475)          | (4,337)          |
| Interest expense .....  | (8,881)                                | (6,819)          | (6,339)          |
| Tax benefit of interest expense and other<br>parent company current tax adjustments ..... | <u>8,666</u>                           | <u>7,626</u>     | <u>(2,087)</u>   |
| Combined net income (loss) .....  | 74,975                                 | 53,949           | (147)            |
| Increase (decrease) due to:   |  |                  |                  |
| Deferred policy acquisition costs .....   | 17,873                                 | 17,607           | 19,836           |
| Policyholder benefits .....   | (424,864)                              | 41,448           | 126,999          |
| Reserve adjustment on life reinsurance ceded .....  | 447,384                                | (10,000)         | (118,813)        |
| Federal income tax expense .....  | (31,460)                               | (14,038)         | 5,101            |
| Amortization of intangible assets .....   | (5,141)                                | (5,990)          | (5,027)          |
| Investment reserves .....   | 3,482                                  | 834              | 6,446            |
| Other adjustments, net .....  | (4,976)                                | (27,497)         | (15,420)         |
| Net income as reported herein .....   | <u>\$ 77,273</u>                       | <u>\$ 56,313</u> | <u>\$ 18,975</u> |

The Company has principal insurance subsidiaries domiciled in Illinois, California and Texas. The statutory financial statements of these subsidiaries are prepared in accordance with accounting principles prescribed or permitted by the Illinois Department of Insurance, the California Department of Insurance and the Texas Department of Insurance, as applicable. Prescribed statutory accounting principles include a variety of publications of the National Association of Insurance Commissioners ("NAIC"), as well as state laws, regulations and general administrative rules.

## **NOTE 8 - Statutory Surplus and Subsidiary Dividend Restrictions-(Continued)**

The Company's insurance subsidiaries are subject to various regulatory restrictions which limit the amount of annual dividends or other distributions, including loans or cash advances, available to HMEC without prior approval of the insurance regulatory authorities. The aggregate amount of dividends that may be paid by the insurance subsidiaries to HMEC during 2006 without prior approval is approximately \$74,000.

The NAIC has adopted risk-based capital guidelines to evaluate the adequacy of statutory capital and surplus in relation to risks assumed in investments, reserving policies, and volume and types of insurance business written. State insurance regulations prohibit insurance companies from making any public statements or representations with regard to their risk-based capital levels. Based on current guidelines, the risk-based capital statutory requirements are not expected to have a negative regulatory impact on the Company's insurance subsidiaries. At December 31, 2005 and 2004, statutory capital and surplus of each of the Company's insurance subsidiaries was above required levels.

In the third quarter of 2005, a portion of the proceeds from the issuance of the Senior Notes due 2015 was utilized to make a capital contribution to HMEC's primary life insurance subsidiary, Horace Mann Life Insurance Company, ("HMLIC"), to substantially offset the early recapture of the reinsurance agreement with the United States branch of Sun Life Assurance Company of Canada, described below. This agreement was terminated effective July 1, 2005 for a minimal recapture fee. At the time of this Annual Report on Form 10-K, the Company has no financial reinsurance agreements in effect.

On December 31, 2003, HMLIC entered into a reinsurance agreement with the United States branch of Sun Life Assurance Company of Canada ("SLACC") which replaced the 2002 agreement with Sun Life Reinsurance Company Limited, a member of the Sun Life Financial Group. Under the terms of the December 31, 2003 agreement, which was written to be in place for a five year period, HMLIC ceded to SLACC, on a combination coinsurance and modified coinsurance basis, a 75% quota share of HMLIC's in force interest-sensitive life block of business issued prior to January 1, 2002. SLACC assumed its proportional share of all risks attendant to the business reinsured such as mortality, persistency and investment risk, reducing HMLIC's liabilities under statutory accounting principles to the extent of the ceded commission. The initial ceded commission received by HMLIC was \$50,000 and resulted in a \$32,500 after-tax increase in HMLIC's statutory surplus. These transactions improved the statutory operating leverage and risk-based capital ratio of HMLIC in 2004, 2003 and 2002, but did not impact reported GAAP capitalization. The agreement provided that HMLIC could recapture the agreement without penalty after giving 30 days written notice.

## **NOTE 9 - Pension Plans and Other Postretirement Benefits**

The Company has the following retirement plans: a defined contribution plan; a 401(k) plan; a defined benefit plan for employees hired on or before December 31, 1998; and certain employees participate in a supplemental defined benefit plan or a supplemental defined contribution plan or both.

After completing the first year of employment, all employees participate in the defined contribution plan. Under this plan, the Company makes contributions to each participant's account based on eligible compensation and years of service. Contribution percentages are currently as follows: (1) employees hired on or after April 1, 1997, 5% of eligible compensation; (2) employees hired prior to April 1, 1997 with less than 15 years of service, 6% of eligible compensation; and (3) employees hired prior to April 1, 1997 with 15 or more years of service, 7% of eligible compensation. Participants are 100% vested in this plan after 5 years of service.

All employees of the Company participate in a 401(k) plan. Beginning January 1, 2002, the Company automatically contributes 3% of eligible compensation to each employee's account, which is 100% vested at the time of the contribution. In addition, employees may voluntarily contribute up to 20% of their eligible compensation into their account.

Effective April 1, 2002, participants stopped accruing benefits under the defined benefit and supplemental defined benefit plans but continue to retain the benefits they had accrued to date. Amounts earned under the defined benefit and supplemental defined benefit plans have been based on years of service and the highest 36 consecutive months of earnings while under the plan (through March 31, 2002). Participants are 100% vested in these defined benefit plans after 5 years of service.

The Company's policy with respect to funding the defined benefit plan is to contribute amounts which are actuarially determined to provide the plan with sufficient assets to meet future benefit payments consistent with the funding requirements of federal laws and regulations. For the defined contribution, 401(k) and defined benefit plans, investments have been set aside in a trust fund. The supplemental retirement plans are unfunded, non-qualified plans.

Employees whose compensation exceeds the limits covered under the qualified plans participate in an unfunded, non-qualified defined contribution plan. The Company accrues an amount for each participant based on their compensation, years of service and account balance. Participants are 100% vested in this plan after 5 years of service.

Total expense recorded for the qualified and non-qualified defined contribution, 401(k), defined benefit and supplemental plans was \$14,647, \$13,862 and \$15,347 for the years ended December 31, 2005, 2004 and 2003, respectively.

**NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)**

*Qualified Defined Contribution Plan, 401(k) Plan and Non-qualified Defined Contribution Plan*

Pension benefits under the qualified defined contribution plan were fully funded. Contributions to employees' accounts under this plan were expensed in the Company's Consolidated Statements of Operations. Investments for this plan were set aside in a trust fund and none of the trust fund assets for the plan have been invested in shares of HMEC's common stock.

The 401(k) plan was fully funded. Contributions to employees' accounts under this plan were expensed in the Company's Consolidated Statements of Operations. Investments for this plan were set aside through an annuity contract underwritten by the Company's principal life insurance subsidiary. The annuity contract includes a fixed return account option and several variable return account options, with the account options selected by the individual plan participants. One of the variable return account options invests in shares of HMEC common stock.

The non-qualified defined contribution plan is an unfunded plan. Contributions to employees' accounts under the non-qualified defined contribution plan are equal to cash payments to retirees for the period.

Contributions to employees' accounts under the qualified defined contribution plan, the 401(k) plan and the non-qualified defined contribution plan, as well as total assets of the plans, were as follows:

|   | <u>Year Ended December 31,</u> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <u>2005</u>                    | <u>2004</u> | <u>2003</u> |
| Qualified defined contribution plan:      |                                |             |             |
| Contributions to employees accounts.....  | \$ 6,205                       | \$ 5,920    | \$ 5,818    |
| Total assets at the end of the year ..... | 126,666                        | 118,499     | 112,795     |
| 401(k) plan:                              |                                |             |             |
| Contributions to employees accounts.....  | 3,758                          | 3,574       | 3,705       |
| Total assets at the end of the year ..... | 110,183                        | 102,555     | 94,020      |
| Non-qualified defined contribution plan:  |                                |             |             |
| Contributions to employees accounts.....  | 260                            | 191         | -           |
| Total assets at the end of the year ..... | -                              | -           | -           |

## NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)

### Defined Benefit Plan and Supplemental Retirement Plans

The following tables summarize both the funding status of the defined benefit and supplemental retirement pension plans and identify the assumptions used to determine the projected benefit obligation and the components of net pension cost for the defined benefit plan and supplemental retirement plans for the following periods:

|  | Defined Benefit Plan |                   |                   | Supplemental Retirement Plans |                   |                   |
|--|----------------------|-------------------|-------------------|-------------------------------|-------------------|-------------------|
|  | December 31,         |                   |                   | December 31,                  |                   |                   |
|  | 2005                 | 2004              | 2003              | 2005                          | 2004              | 2003              |
| Change in benefit obligation:  |                      |                   |                   |                               |                   |                   |
| Projected benefit obligation   |                      |                   |                   |                               |                   |                   |
| at beginning of year .....   | \$ 49,504            | \$ 53,261         | \$ 50,402         | \$ 16,508                     | \$ 15,126         | \$ 15,148         |
| Service cost.....  | -                    | -                 | -                 | (41)                          | (29)              | 416               |
| Interest cost .....  | 2,642                | 2,916             | 3,258             | 917                           | 964               | 971               |
| Actuarial loss (gain).....   | 1,592                | (774)             | 8,569             | 363                           | 1,462             | (190)             |
| Benefits paid .....  | (1,597)              | (1,594)           | (2,022)           | (1,293)                       | (1,015)           | (1,219)           |
| Settlements .....  | (3,582)              | (4,305)           | (6,946)           | -                             | -                 | -                 |
| Projected benefit obligation at end of year ..   | <u>\$ 48,559</u>     | <u>\$ 49,504</u>  | <u>\$ 53,261</u>  | <u>\$ 16,454</u>              | <u>\$ 16,508</u>  | <u>\$ 15,126</u>  |
| Change in plan assets:   |                      |                   |                   |                               |                   |                   |
| Fair value of plan assets  |                      |                   |                   |                               |                   |                   |
| at beginning of year .....   | \$ 34,884            | \$ 33,729         | \$ 28,105         | \$ -                          | \$ -              | \$ -              |
| Actual return on plan assets.....  | 1,969                | 3,554             | 5,812             | -                             | -                 | -                 |
| Employer contributions.....  | 4,514                | 3,500             | 8,780             | 1,293                         | 1,015             | 1,219             |
| Benefits paid .....  | (1,597)              | (1,594)           | (2,022)           | (1,293)                       | (1,015)           | (1,219)           |
| Settlements .....  | (3,582)              | (4,305)           | (6,946)           | -                             | -                 | -                 |
| Fair value of plan assets at end of year.....  | <u>\$ 36,188</u>     | <u>\$ 34,884</u>  | <u>\$ 33,729</u>  | <u>\$ -</u>                   | <u>\$ -</u>       | <u>\$ -</u>       |
| Funded status .....  | \$(12,371)           | \$(14,620)        | \$(19,532)        | \$(16,454)                    | \$(16,508)        | \$(15,126)        |
| Unrecognized net actuarial loss.....   | 17,578               | 18,364            | 22,860            | 4,361                         | 4,624             | 3,681             |
| Prepaid (accrued) benefit cost included  |                      |                   |                   |                               |                   |                   |
| in the Consolidated Balance Sheets.....  | 5,207                | 3,744             | 3,328             | (12,093)                      | (11,884)          | (11,445)          |
| Additional liability to recognize unfunded   |                      |                   |                   |                               |                   |                   |
| accumulated benefit obligation.....  | (17,578)             | (18,364)          | (22,860)          | (4,423)                       | (4,701)           | (3,681)           |
| Total benefit cost .....   | <u>\$(12,371)</u>    | <u>\$(14,620)</u> | <u>\$(19,532)</u> | <u>\$(16,516)</u>             | <u>\$(16,585)</u> | <u>\$(15,126)</u> |
| Amounts recognized in the Consolidated Balance Sheets  |                      |                   |                   |                               |                   |                   |
| consist of:  |                      |                   |                   |                               |                   |                   |
| Accrued benefit cost .....   | \$ 5,207             | \$ 3,744          | \$ 3,328          | \$(12,093)                    | \$(11,884)        | \$(11,445)        |
| Minimum liability .....  | (17,578)             | (18,364)          | (22,860)          | (4,423)                       | (4,701)           | (3,681)           |
| Accumulated other  |                      |                   |                   |                               |                   |                   |
| comprehensive income .....   | 17,578               | 18,364            | 22,860            | 4,423                         | 4,701             | 3,681             |
| Net amount recognized .....  | <u>\$ 5,207</u>      | <u>\$ 3,744</u>   | <u>\$ 3,328</u>   | <u>\$(12,093)</u>             | <u>\$(11,884)</u> | <u>\$(11,445)</u> |
| Information for pension plans with an accumulated benefit obligation greater than plan assets: |                      |                   |                   |                               |                   |                   |
| Projected benefit obligation .....   | \$ 48,559            | \$ 49,504         | \$ 53,261         | \$ 16,454                     | \$ 16,508         | \$ 15,126         |
| Accumulated benefit obligation.....  | 48,559               | 49,504            | 53,261            | 16,454                        | 16,508            | 15,126            |
| Fair value of plan assets.....   | 36,188               | 34,884            | 33,729            | -                             | -                 | -                 |

## NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)

The decreases in the Company's 2005 and 2004 minimum pension liability for the defined contribution plan of \$786 and \$4,496, respectively, were primarily attributable to improvements in asset performance and decreases in settlements. These changes were recorded to a separate component of shareholders' equity.

|   | Defined Benefit Plan    |                 |                 | Supplemental Retirement Plans |                 |                 |
|---|-------------------------|-----------------|-----------------|-------------------------------|-----------------|-----------------|
|   | Year Ended December 31, |                 |                 | Year Ended December 31,       |                 |                 |
|   | 2005                    | 2004            | 2003            | 2005                          | 2004            | 2003            |
| Components of net periodic pension (income) expense:                                  |                         |                 |                 |                               |                 |                 |
| Service cost.....   | \$ -                    | \$ -            | \$ -            | \$ (41)                       | \$ (29)         | \$ 416          |
| Interest cost .....   | 2,642                   | 2,916           | 3,258           | 917                           | 964             | 971             |
| Expected return on plan assets.....   | (2,504)                 | (2,730)         | (2,490)         | -                             | -               | -               |
| Recognized net actuarial loss .....   | 1,616                   | 1,217           | 1,675           | 626                           | 519             | 265             |
| Settlement loss.....  | 1,297                   | 1,682           | 3,104           | -                             | -               | -               |
| Net periodic pension expense .....  | <u>\$ 3,051</u>         | <u>\$ 3,085</u> | <u>\$ 5,547</u> | <u>\$ 1,502</u>               | <u>\$ 1,454</u> | <u>\$ 1,652</u> |
| Weighted-average assumptions used to determine expense:                               |                         |                 |                 |                               |                 |                 |
| Discount rate .....   | 5.75%                   | 6.25%           | 6.38%           | 5.75%                         | 6.25%           | 6.75%           |
| Expected return on plan assets.....   | 7.50%                   | 7.50%           | 7.50%           | *                             | *               | *               |
| Annual rate of salary increase.....   | *                       | *               | *               | *                             | *               | *               |
| Weighted-average assumptions used to determine benefit obligations as of December 31: |                         |                 |                 |                               |                 |                 |
| Discount rate .....   | 5.50%                   | 5.75%           | 6.25%           | 5.50%                         | 5.75%           | 6.25%           |
| Expected return on plan assets.....   | 7.50%                   | 7.50%           | 7.50%           | *                             | *               | *               |
| Annual rate of salary increase.....   | *                       | *               | *               | *                             | *               | *               |

\* Not applicable.

The assumption for the long-term rate of return on plan assets was determined by considering actual investment experience during the lifetime of the plan, balanced with reasonable expectations of future growth considering the various classes of assets and percentage allocation for each asset class.

The allocation by asset category of the Company's defined benefit pension plan assets at December 31, 2005, 2004 and 2003 (the measurement dates) were as follows:

| Asset category                        | December 31,  |               |               |
|---------------------------------------|---------------|---------------|---------------|
|                                       | 2005          | 2004          | 2003          |
| Equity securities (1).....            | 69.0%         | 67.8%         | 71.3%         |
| Debt securities .....                 | 29.8          | 29.2          | 26.7          |
| Cash and short-term investments ..... | 1.2           | 3.0           | 2.0           |
| Total .....                           | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> |

(1) None of the trust fund assets for the defined benefit pension plan have been invested in shares of HMEC's common stock.

## NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)

In 2002, the Company adopted an investment policy for the defined benefit pension plan that aligns the assets within the plan's trust to an approximate 70% equity and 30% stable value funds allocation. Management believes this allocation will produce the targeted long-term rate of return on assets necessary for payment of future benefit obligations, while providing adequate liquidity for payments to current beneficiaries. During 2003, assets were rebalanced to reflect the defined benefit pension plan's investment policy and the trustee has been directed to review and adjust invested assets at least quarterly to maintain the target allocation percentages.

The Company expects to contribute \$7,000 to the defined benefit plan and \$1,057 to the supplemental retirement plans in 2006.

### *Postretirement Benefits Other than Pensions*

In addition to providing pension benefits, the Company also provides certain health care and life insurance benefits to retired employees and eligible dependents. Effective January 1, 2001, the eligibility requirement was age 55 and 20 years of service. Employees hired on or after January 1, 2001 are not eligible for postretirement medical benefits. Effective January 1, 2004, only employees who were at least age 50 with at least 15 years of service by December 31, 2003 are eligible to participate in this program. Postretirement benefits other than pensions of active and retired employees are accrued as expense over the employees' service years.

The following table presents the funded status of postretirement benefits other than pensions of active and retired employees (including employees on disability more than 2 years) as of December 31, 2005, 2004 and 2003 (the measurement dates) reconciled with amounts recognized in the Company's Consolidated Balance Sheets:

|   | December 31,            |                   |                   |
|---|-------------------------|-------------------|-------------------|
|   | 2005                    | 2004              | 2003              |
| Change in accumulated postretirement benefit obligation:                            |                         |                   |                   |
| Accumulated postretirement benefit obligation at beginning of year .....            | \$ 32,314               | \$ 30,237         | \$ 37,087         |
| Changes during fiscal year  |                         |                   |                   |
| Service cost .....  | 81                      | 102               | 248               |
| Interest cost .....   | 1,507                   | 1,803             | 1,972             |
| Plan amendments .....   | -                       | -                 | (3,947)           |
| Benefits paid .....   | (1,773)                 | (2,229)           | (2,301)           |
| Actuarial (gain) loss .....   | (8,765)                 | 2,401             | (2,822)           |
| Accumulated postretirement benefit obligation at end of year .....                  | <u>\$ 23,364</u>        | <u>\$ 32,314</u>  | <u>\$ 30,237</u>  |
| Unfunded status .....   | \$(23,364)              | \$(32,314)        | \$(30,237)        |
| Unrecognized prior service cost .....   | (2,152)                 | (2,870)           | (3,588)           |
| Unrecognized net (gain) loss from past experience different from that assumed ..... | (2,498)                 | 6,267             | 3,954             |
| Accrued postretirement benefit cost .....   | <u>\$(28,014)</u>       | <u>\$(28,917)</u> | <u>\$(29,871)</u> |
|   |                         |                   |                   |
|   | Year Ended December 31, |                   |                   |
|   | 2005                    | 2004              | 2003              |
| Components of net periodic benefit cost:  |                         |                   |                   |
| Service cost .....  | \$ 81                   | \$ 102            | \$ 248            |
| Interest cost .....   | 1,507                   | 1,803             | 1,972             |
| Amortization of prior service cost .....  | (718)                   | (718)             | (359)             |
| Amortization of prior losses .....  | -                       | 88                | 58                |
| Net periodic benefit cost .....   | <u>\$ 870</u>           | <u>\$ 1,275</u>   | <u>\$ 1,919</u>   |

The Company expects to contribute \$2,072 to the postretirement benefit plan in 2006.

**NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)**

*Sensitivity Analysis for Postretirement Benefits Other than Pensions*

A one percentage point change in the assumed health care cost trend rate for each year would change the accumulated postretirement benefit obligation as follows:

|   | <u>December 31,</u> |             |             |
|---|---------------------|-------------|-------------|
|   | <u>2005</u>         | <u>2004</u> | <u>2003</u> |
| Accumulated postretirement benefit obligation   |                     |             |             |
| Effect of a one percentage point increase .....   | \$ 231              | \$ 879      | \$ 799      |
| Effect of a one percentage point decrease .....   | (200)               | (783)       | (710)       |
| Service and interest cost components of the net periodic postretirement benefit expense                   |                     |             |             |
| Effect of a one percentage point increase .....   | \$ 39               | \$ 48       | \$ 54       |
| Effect of a one percentage point decrease .....   | (35)                | (43)        | (48)        |
| Weighted average assumptions used to determine benefit obligation as of December 31:                      |                     |             |             |
| Discount rate .....   | 5.50%               | 5.75%       | 6.25%       |
| Healthcare cost trend rate .....  | 11.00%              | 12.00%      | 11.00%      |
| Rate to which the cost trend rate is assumed to decline (ultimate trend rate) .....                       | 5.50%               | 5.50%       | 5.50%       |
| Year the rate is assumed to reach the ultimate trend rate ..  | 2012                | 2012        | 2009        |
| Expected return on plan assets .....  | *                   | *           | *           |
| Weighted-average assumptions used to determine net periodic benefit cost for the years ended December 31: |                     |             |             |
| Discount rate .....   | 5.75%               | 6.25%       | 6.25%       |
| Healthcare cost trend rate .....  | 12.00%              | 10.00%      | 11.00%      |
| Rate to which the cost trend rate is assumed to decline (ultimate trend rate) .....                       | 5.50%               | 5.50%       | 5.50%       |
| Year the rate is assumed to reach the ultimate trend rate ..  | 2012                | 2009        | 2009        |
| Expected return on plan assets .....  | *                   | *           | *           |

\* Not applicable.

The discount rates at December 31, 2005 were based on the average yield for long-term, high-grade securities available during the benefit payout period. To set its discount rate, the Company looks to leading indicators, including Moody's Aa long-term bond index.

In May 2004, the FASB issued FASB Staff Position ("FSP") No. FAS 106-2, providing guidance on the accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 ("the Act") for employers that sponsor postretirement health care plans that provide prescription drug benefits. The Company has determined that the retiree prescription drug benefits provided by the plan are actuarially equivalent to the Medicare Part D benefit under the Act, and is thus eligible for the federal retiree drug subsidy beginning in 2006. As a result, the Company's accumulated postretirement benefit obligation and net periodic cost for 2005 were reduced by \$5,967 and \$101, respectively.

## NOTE 9 - Pension Plans and Other Postretirement Benefits-(Continued)

### Estimated Future Benefit Payments (Receipts)

The Company's defined benefit and supplemental defined benefit plans are subject to settlement accounting. Assumptions for both the number of individuals retiring in a calendar year and their elections regarding lump sum distributions are significant factors impacting the payout patterns for these plans. Therefore, actual results could vary from the estimates below. Estimated future benefit payments and subsidy receipts at December 31, 2005 are as follows:

|   | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011-2015</u> |
|---|-------------|-------------|-------------|-------------|-------------|------------------|
| Pension plans:                          |             |             |             |             |             |                  |
| Defined benefit plan.....               | \$7,261     | \$4,694     | \$4,461     | \$4,081     | \$4,108     | \$17,911         |
| Supplemental retirement plans .....     | 1,057       | 1,209       | 1,216       | 1,221       | 1,223       | 6,156            |
| Postretirement benefits .....           | 2,072       | 2,131       | 2,239       | 2,303       | 2,362       | 11,907           |
| Anticipated Medicare Part D subsidy.... | (259)       | (296)       | (337)       | (383)       | (424)       | (2,803)          |

## NOTE 10 - Catastrophes and Reinsurance

In the normal course of business, the Company's insurance subsidiaries assume and cede reinsurance with other insurers. Reinsurance is ceded primarily to limit losses from large exposures and to permit recovery of a portion of direct losses; however, such a transfer does not relieve the originating insurance company of contingent liability.

The Company is a national underwriter and therefore has exposure to catastrophic losses in certain coastal states and other regions throughout the U.S. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather and fires, and the frequency and severity of catastrophes are inherently unpredictable. The financial impact from catastrophic losses results from both the total amount of insured exposure in the area affected by the catastrophe as well as the severity of the event. The Company seeks to reduce its exposure to catastrophe losses through the geographic diversification of its insurance coverage, deductibles, maximum coverage limits, the purchase of catastrophe reinsurance, and, prior to May 7, 2005, the purchase of a catastrophe-linked equity put option and reinsurance agreement, described below.

The Company's net catastrophe losses incurred of approximately \$59,293 for the year ended December 31, 2005 primarily reflected losses from Hurricane Katrina, Hurricane Rita, Minnesota storms, Hurricane Dennis and Hurricane Wilma which totaled \$52,025. The Company's net catastrophe losses incurred of approximately \$70,460 for the year ended December 31, 2004 were at a record high level for the Company and primarily reflected losses from Hurricanes Charley, Frances, Ivan and Jeanne, which totaled \$64,196.

The total amounts of reinsurance recoverable on unpaid insurance reserves classified as assets and reported in Other Assets in the Consolidated Balance Sheets were as follows:

|  | <u>December 31,</u> |                 |
|--|---------------------|-----------------|
|  | <u>2005</u>         | <u>2004</u>     |
| Reinsurance recoverables on reserves and unpaid claims |                     |                 |
| Life and health.....                                   | \$ 7,949            | \$ 7,274        |
| Property and casualty                                  |                     |                 |
| State insurance facilities .....                       | 5,161               | 5,380           |
| Other insurance companies.....                         | <u>26,443</u>       | <u>20,342</u>   |
| Total .....  | <u>\$39,553</u>     | <u>\$32,996</u> |

## NOTE 10 - Catastrophes and Reinsurance-(Continued)

The Company recognizes the cost of reinsurance premiums over the contract periods for such premiums in proportion to the insurance protection provided. Amounts recoverable from reinsurers for unpaid claims and claim settlement expenses, including estimated amounts for unsettled claims, claims incurred but not reported and policy benefits are estimated in a manner consistent with the insurance liability associated with the policy. The effect of reinsurance on premiums written and contract deposits, premiums and contract charges earned, and benefits, claims and settlement expenses were as follows:

|  | <u>Gross<br/>Amount</u> | <u>Ceded to<br/>Other<br/>Companies</u> | <u>Assumed<br/>from Other<br/>Companies</u> | <u>Net</u> |
|--|-------------------------|---|---|------------|
| <b>Year ended December 31, 2005</b>            |                         |   |   |            |
| Premiums written and contract deposits         | \$997,852               | \$35,969                                | \$10,759                                    | \$972,642  |
| Premiums and contract charges earned           | 688,532                 | 36,338                                  | 12,745                                      | 664,939    |
| Benefits, claims and settlement expenses ..... | 516,363                 | 85,781                                  | 12,135                                      | 442,717    |
| <b>Year ended December 31, 2004</b>            |                         |   |   |            |
| Premiums written and contract deposits         | 1,010,816               | 31,445                                  | 18,985                                      | 998,356    |
| Premiums and contract charges earned           | 686,732                 | 31,518                                  | 19,490                                      | 674,704    |
| Benefits, claims and settlement expenses ..... | 581,866                 | 110,736                                 | 13,280                                      | 484,410    |
| <b>Year ended December 31, 2003</b>            |                         |   |   |            |
| Premiums written and contract deposits         | 971,213                 | 23,038                                  | 7,284                                       | 955,459    |
| Premiums and contract charges earned           | 658,171                 | 22,249                                  | 7,614                                       | 643,536    |
| Benefits, claims and settlement expenses ..... | 523,205                 | 8,342                                   | 4,115                                       | 518,978    |

Gross and ceded benefits, claims and settlement expenses for the year ended December 31, 2005 reflect the impact of property and casualty losses from Hurricane Katrina, Hurricane Rita, Minnesota storms, Hurricane Dennis and Hurricane Wilma. Gross and ceded benefits, claims and settlement expenses for the year ended December 31, 2004 reflect the impact of property and casualty losses from Hurricanes Charley, Frances, Ivan and Jeanne. Ceded premiums written and earned for the years ended December 31, 2005 and 2004 included approximately \$10,000 and \$5,000, respectively, of catastrophe reinsurance reinstatement premium.

There were no losses from uncollectible reinsurance recoverables in the three years ended December 31, 2005. Past due reinsurance recoverables as of December 31, 2005 were not material.

The Company maintains an excess and catastrophe treaty reinsurance program. Effective January 1, 2005, the Company reinsured 95% of catastrophe losses above a retention of \$10,000 per occurrence up to \$80,000 per occurrence. The catastrophe treaty coverage consisted of four layers, each of which provided for one mandatory reinstatement. The four layers were \$5,000 excess of \$10,000, \$10,000 excess of \$15,000, \$15,000 excess of \$25,000 and \$40,000 excess of \$40,000. In addition, the Company's predominant insurance subsidiary for property and casualty business written in Florida reinsures 90% of hurricane losses in that state above a retention of \$13,200 up to \$60,900 with the Florida Hurricane Catastrophe Fund ("FHCF"), based on the FHCF's financial resources. The FHCF contract is a one-year contract, effective June 1. Through May 7, 2005, these catastrophe reinsurance programs were augmented by a \$75,000 equity put and reinsurance agreement, as further discussed below.

## **NOTE 10 - Catastrophes and Reinsurance-(Continued)**

Effective May 7, 2002, the Company entered into a 36-month equity put and reinsurance agreement with a subsidiary of Swiss Reinsurance Company, which augmented the reinsurance programs above and provided a source of up to \$75,000 of contingent capital for catastrophe losses above the Company's reinsurance coverage limits. Due to relatively unfavorable pricing and terms, the Company elected not to renew this agreement on the May 7, 2005 expiration date. Management believes that the Company's current catastrophe protection as well as other potential sources of capital would be sufficient in the event of excessive catastrophe losses.

For liability coverages, including the educator excess professional liability policy, the Company reinsures each loss above a retention of \$500 up to \$20,000. For property coverages, the Company reinsures each loss above a retention of \$500 up to \$2,500, including catastrophe losses that in the aggregate are less than the retention levels above.

The maximum individual life insurance risk retained by the Company is \$200 on any individual life and a maximum of \$100 or \$125 is retained on each group life policy depending on the type of coverage. Excess amounts are reinsured. The Company also maintains a life catastrophe reinsurance program. The Company reinsured 100% of the catastrophe risk in excess of \$1,000 up to \$20,000 per occurrence through December 31, 2003 and in excess of \$1,000 up to \$15,000 per occurrence effective January 1, 2004. This program covers acts of terrorism but excludes nuclear, biological and chemical explosions as well as other acts of war.

## **NOTE 11 - Contingencies and Commitments**

### *Lawsuits and Legal Proceedings*

Companies in the insurance industry have been subject to substantial litigation resulting from claims, disputes and other matters. Most recently, they have faced expensive claims, including class action lawsuits, alleging, among other things, improper sales practices and improper claims settlement procedures. Negotiated settlements of certain such actions have had a material adverse effect on many insurance companies.

There are various lawsuits and legal proceedings against the Company. Management and legal counsel are of the opinion that the ultimate disposition of such litigation will have no material adverse effect on the Company's financial position.

### *Assessments for Insolvencies of Unaffiliated Insurance Companies*

The Company is also contingently liable for possible assessments under regulatory requirements pertaining to potential insolvencies of unaffiliated insurance companies. Liabilities, which are established based upon regulatory guidance, have generally been insignificant.

**NOTE 11 - Contingencies and Commitments-(Continued)**

*Leases*

The Company has entered into various operating lease agreements, primarily for real estate (agency and claims offices across the country and portions of the home office complex) and also for computer equipment. Rental expenses were \$10,766, \$9,754 and \$9,536 for the years ended December 31, 2005, 2004 and 2003, respectively. Future minimum lease payments under leases expiring subsequent to December 31, 2005 are as follows:

|                                       | Year Ended December 31, 2005 |             |             |             |             |                  |
|---------------------------------------|------------------------------|-------------|-------------|-------------|-------------|------------------|
|                                       | <u>2006</u>                  | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011-2015</u> |
| Minimum operating lease payments..... | \$4,473                      | \$2,402     | \$664       | \$158       | \$80        | -                |

**NOTE 12 - Supplementary Data on Cash Flows**

A reconciliation of net income to net cash provided by operating activities as presented in the Consolidated Statements of Cash Flows is as follows:

|   | Year Ended December 31, |                  |                  |
|---|-------------------------|------------------|------------------|
|   | <u>2005</u>             | <u>2004</u>      | <u>2003</u>      |
| Cash flows from operating activities  |                         |                  |                  |
| Net income .....  | \$ 77,273               | \$ 56,313        | \$ 18,975        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |                  |                  |
| Realized investment gains .....   | (9,841)                 | (12,197)         | (25,487)         |
| Depreciation and amortization.....  | 10,243                  | 11,046           | 11,082           |
| Increase in insurance liabilities.....  | 92,426                  | 122,360          | 151,928          |
| (Increase) decrease in premium receivables.....                                   | 3,648                   | (2,404)          | 634              |
| Increase in deferred policy acquisition costs.....                                | (24,054)                | (15,873)         | (19,835)         |
| (Increase) decrease in reinsurance recoverable .....                              | (7,098)                 | 949              | 1,110            |
| Increase (decrease) in federal income tax liabilities .....                       | 18,058                  | 10,596           | (18,791)         |
| Decrease in liabilities for restructuring and litigation charges.....             | (516)                   | (286)            | (3,101)          |
| Other .....   | <u>5,027</u>            | <u>(3,226)</u>   | <u>5,319</u>     |
| Total adjustments.....  | <u>87,893</u>           | <u>110,965</u>   | <u>102,859</u>   |
| Net cash provided by operating activities .....                                   | <u>\$165,166</u>        | <u>\$167,278</u> | <u>\$121,834</u> |

The Company's repurchases of debt in 2005 resulted in non-cash financing charges of \$30.

## NOTE 13 - Segment Information

The Company conducts and manages its business through four segments. The three operating segments, representing the major lines of insurance business, are: property and casualty insurance, principally personal lines automobile and homeowners products; annuity products, principally individual, tax-qualified fixed and variable deposits; and life insurance. The Company does not allocate the impact of corporate level transactions to the insurance segments, consistent with management's evaluation of the results of those segments, but classifies those items in the fourth segment, corporate and other. In addition to debt service, realized investment gains and losses and certain public company expenses, such charges historically have included restructuring charges, debt retirement costs, litigation charges and the provision for prior years' taxes.

The accounting policies of the segments are the same as those described in "Note 1 -- Summary of Significant Accounting Policies". The Company accounts for intersegment transactions, primarily the allocation of agent and overhead costs from the corporate and other segment to the property and casualty, annuity and life segments, on a direct cost basis.

Summarized financial information for these segments is as follows:

|  | <u>Year Ended December 31,</u> |                    |                    |
|--|--------------------------------|--------------------|--------------------|
|  | <u>2005</u>                    | <u>2004</u>        | <u>2003</u>        |
| <b>Insurance premiums and contract charges earned</b>                                |                                |                    |                    |
| Property and casualty .....  | \$ 549,587                     | \$ 561,287         | \$ 533,761         |
| Annuity.....   | 17,904                         | 16,708             | 14,588             |
| Life.....  | 97,448                         | 96,709             | 96,004             |
| Intersegment eliminations.....   | -                              | -                  | (817)              |
| Total .....  | <u>\$ 664,939</u>              | <u>\$ 674,704</u>  | <u>\$ 643,536</u>  |
| <b>Net investment income</b>   |                                |                    |                    |
| Property and casualty .....  | \$ 33,236                      | \$ 33,793          | \$ 31,892          |
| Annuity.....   | 112,908                        | 109,393            | 104,380            |
| Life.....  | 49,334                         | 49,490             | 49,605             |
| Corporate and other.....   | 287                            | (80)               | 10                 |
| Intersegment eliminations.....   | (1,133)                        | (1,148)            | (1,162)            |
| Total .....  | <u>\$ 194,632</u>              | <u>\$ 191,448</u>  | <u>\$ 184,725</u>  |
| <b>Net income (loss)</b>   |                                |                    |                    |
| Property and casualty .....  | \$ 45,026                      | \$ 27,587          | \$ (17,805)        |
| Annuity.....   | 15,081                         | 12,646             | 14,353             |
| Life.....  | 13,403                         | 14,751             | 13,431             |
| Corporate and other.....   | 3,763                          | 1,329              | 8,996              |
| Total .....  | <u>\$ 77,273</u>               | <u>\$ 56,313</u>   | <u>\$ 18,975</u>   |
| <b><u>December 31,</u></b>   |                                |                    |                    |
| <b><u>2005</u>                      <u>2004</u>                      <u>2003</u></b> |                                |                    |                    |
| <b>Assets</b>  |                                |                    |                    |
| Property and casualty .....  | \$ 895,467                     | \$ 870,627         | \$ 782,705         |
| Annuity.....   | 3,809,648                      | 3,489,688          | 3,160,704          |
| Life.....  | 1,080,451                      | 962,564            | 946,131            |
| Corporate and other.....   | 79,813                         | 94,513             | 93,047             |
| Intersegment eliminations.....   | (24,772)                       | (45,490)           | (29,372)           |
| Total .....  | <u>\$5,840,607</u>             | <u>\$5,371,902</u> | <u>\$4,953,215</u> |

**NOTE 13 - Segment Information-(Continued)**

Additional significant financial information for these segments is as follows:

|   | <u>Year Ended December 31,</u> |                 |                  |
|---|--------------------------------|-----------------|------------------|
|   | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>      |
| Amortization of deferred policy acquisition costs |                                |                 |                  |
| Property and casualty .....                       | \$57,202                       | \$56,141        | \$ 56,904        |
| Annuity.....                                      | 6,340                          | 4,364           | 767              |
| Life.....   | 7,921                          | 9,496           | 7,491            |
| Intersegment eliminations.....                    | -                              | -               | (817)            |
| Total .....                                       | <u>\$71,463</u>                | <u>\$70,001</u> | <u>\$ 64,345</u> |
| Amortization of intangible assets                 |                                |                 |                  |
| Value of acquired insurance in force              |                                |                 |                  |
| Annuity.....                                      | \$ 3,681                       | \$ 4,453        | \$ 3,402         |
| Life .....  | 1,460                          | 1,537           | 1,625            |
| Total .....                                       | <u>\$ 5,141</u>                | <u>\$ 5,990</u> | <u>\$ 5,027</u>  |
| Income tax expense (benefit)                      |                                |                 |                  |
| Property and casualty .....                       | \$12,996                       | \$ 1,879        | \$(17,367)       |
| Annuity.....                                      | 1,201                          | 3,686           | 5,413            |
| Life.....   | 8,926                          | 7,282           | 7,343            |
| Corporate and other.....                          | (6,352)                        | 597             | 4,815            |
| Total .....                                       | <u>\$16,771</u>                | <u>\$13,444</u> | <u>\$ 204</u>    |

## NOTE 14 - Unaudited Selected Quarterly Financial Data

Selected quarterly financial data is presented below.

|  | Three Months Ended |               |           |           |
|--|--------------------|---------------|-----------|-----------|
|  | December 31,       | September 30, | June 30,  | March 31, |
| <b>2005</b>  |                    |               |           |           |
| Insurance premiums written and contract deposits .....                       | \$242,717          | \$248,873     | \$247,302 | \$233,750 |
| Total revenues .....   | 220,447            | 207,386       | 220,951   | 220,628   |
| Net income .....   | 16,097             | 1,021         | 33,507    | 26,648    |
| Per share information  |                    |               |           |           |
| Basic  |                    |               |           |           |
| Net income .....   | \$ 0.37            | \$ 0.02       | \$ 0.78   | \$ 0.62   |
| Shares of common stock - weighted average (a) .                              | 42,965             | 42,933        | 42,886    | 42,865    |
| Diluted  |                    |               |           |           |
| Net income .....   | \$ 0.35            | \$ 0.02       | \$ 0.72   | \$ 0.57   |
| Shares of common stock and equivalent shares -<br>weighted average (a) ..... | 47,988             | 43,686        | 47,832    | 47,643    |
| <b>2004</b>  |                    |               |           |           |
| Insurance premiums written and contract deposits .....                       | \$241,946          | \$255,558     | \$256,034 | \$244,818 |
| Total revenues .....   | 223,855            | 217,890       | 215,163   | 221,441   |
| Net income (loss) .....  | 28,329             | (12,644)      | 18,937    | 21,691    |
| Per share information  |                    |               |           |           |
| Basic  |                    |               |           |           |
| Net income (loss) .....  | \$ 0.66            | \$ (0.30)     | \$ 0.44   | \$ 0.51   |
| Shares of common stock - weighted average (a) .                              | 42,821             | 42,773        | 42,732    | 42,722    |
| Diluted  |                    |               |           |           |
| Net income (loss) .....  | \$ 0.61            | \$ (0.30)     | \$ 0.41   | \$ 0.47   |
| Shares of common stock and equivalent shares -<br>weighted average (a) ..... | 47,474             | 42,773        | 47,311    | 47,277    |
| <b>2003</b>  |                    |               |           |           |
| Insurance premiums written and contract deposits .....                       | \$249,723          | \$251,436     | \$234,760 | \$219,540 |
| Total revenues .....   | 232,436            | 211,014       | 209,207   | 201,091   |
| Net income (loss) .....  | 23,059             | (14,266)      | 2,083     | 8,099     |
| Per share information  |                    |               |           |           |
| Basic  |                    |               |           |           |
| Net income (loss) .....  | \$ 0.54            | \$ (0.34)     | \$ 0.05   | \$ 0.19   |
| Shares of common stock - weighted average (a) .                              | 42,722             | 42,722        | 42,707    | 42,700    |
| Diluted  |                    |               |           |           |
| Net income (loss) .....  | \$ 0.50            | \$ (0.34)     | \$ 0.05   | \$ 0.19   |
| Shares of common stock and equivalent shares -<br>weighted average (a) ..... | 47,243             | 42,933        | 42,901    | 47,212    |

(a) Rounded to thousands.

## HORACE MANN EDUCATORS CORPORATION

SUMMARY OF INVESTMENTS-OTHER THAN INVESTMENTS IN RELATED PARTIES  
December 31, 2005

(Dollars in thousands)

| <u>Type of Investments</u>                                      | <u>Cost(1)</u>     | <u>Fair Value</u>  | <u>Amount shown in Balance Sheet</u> |
|---|--------------------|--------------------|--------------------------------------|
| Fixed maturities:   |                    |                    |                                      |
| U.S. Government and federally sponsored agency obligations..... | \$ 973,681         | \$ 962,404         | \$ 962,404                           |
| States, municipalities and political subdivisions.....          | 571,172            | 576,815            | 576,815                              |
| Foreign government bonds.....                                   | 29,767             | 31,260             | 31,260                               |
| Public utilities.....   | 172,792            | 178,101            | 178,101                              |
| Other corporate bonds.....                                      | <u>1,907,872</u>   | <u>1,954,722</u>   | <u>1,954,722</u>                     |
| Total fixed maturity securities.....                            | 3,655,284          | <u>\$3,703,302</u> | 3,703,302                            |
| Mortgage loans.....   | 3,612              | XXX                | 3,612                                |
| Short-term investments.....                                     | 8,576              | XXX                | 8,576                                |
| Short-term investments, loaned securities collateral.....       | 192,995            | XXX                | 192,995                              |
| Policy loans and other.....                                     | <u>87,931</u>      | XXX                | <u>88,007</u>                        |
| Total investments.....  | <u>\$3,948,398</u> | XXX                | <u>\$3,996,492</u>                   |

(1) Bonds at original cost reduced by repayments and adjusted for amortization of premiums or accrual of discounts and impairment in value of specifically identified investments.

See accompanying Report of Independent Registered Public Accounting Firm.

**HORACE MANN EDUCATORS CORPORATION**  
(Parent Company Only)

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**BALANCE SHEETS**  
As of December 31, 2005 and 2004  
(Dollars in thousands, except per share data)

|  | December 31,      |                   |
|--|-------------------|-------------------|
|  | 2005              | 2004              |
| <b>ASSETS</b>  |                   |                   |
| Investments and cash .....   | \$ 177            | \$ 184            |
| Investment in subsidiaries .....   | 722,470           | 716,300           |
| Other assets .....   | 51,105            | 51,112            |
| Total assets .....   | <b>\$ 773,752</b> | <b>\$ 767,596</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                   |                   |
| Short-term debt .....  | \$ -              | \$ 25,000         |
| Long-term debt .....   | 190,886           | 144,720           |
| Other liabilities .....  | 2,275             | 21,670            |
| Total liabilities .....  | 193,161           | 191,390           |
| Preferred stock, \$0.001 par value, authorized<br>1,000,000 shares; none issued .....                              | -                 | -                 |
| Common stock, \$0.001 par value, authorized 75,000,000<br>shares; issued, 2005, 60,475,399; 2004, 60,350,014 ..... | 60                | 60                |
| Additional paid-in capital .....   | 345,251           | 343,178           |
| Retained earnings .....  | 553,712           | 494,665           |
| Accumulated other comprehensive income (loss), net of taxes:   |                   |                   |
| Net unrealized gains on fixed maturities and equity securities .....   | 28,446            | 85,872            |
| Minimum pension liability adjustment .....   | (14,301)          | (14,992)          |
| Treasury stock, at cost, 2005 and 2004, 17,503,371 shares .....  | (332,577)         | (332,577)         |
| Total shareholders' equity .....   | 580,591           | 576,206           |
| Total liabilities and shareholders' equity .....   | <b>\$ 773,752</b> | <b>\$ 767,596</b> |

See accompanying note to condensed financial statements.

See accompanying Report of Independent Registered Public Accounting Firm.

**HORACE MANN EDUCATORS CORPORATION**  
**(Parent Company Only)**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**STATEMENTS OF OPERATIONS**

(Dollars in thousands)

|  | <u>Year Ended December 31,</u> |                  |                  |
|--|--------------------------------|------------------|------------------|
|  | <u>2005</u>                    | <u>2004</u>      | <u>2003</u>      |
| Revenues   |                                |                  |                  |
| Net investment income .....  | \$ 288                         | \$ (76)          | \$ 19            |
| Realized investment gains (losses) .....                                     | <u>-</u>                       | <u>(237)</u>     | <u>62</u>        |
| Total revenues .....   | <u>288</u>                     | <u>(313)</u>     | <u>81</u>        |
| Expenses   |                                |                  |                  |
| Interest.....  | 8,881                          | 6,819            | 6,339            |
| Other.....   | <u>2,872</u>                   | <u>2,834</u>     | <u>4,629</u>     |
| Total expenses.....  | <u>11,753</u>                  | <u>9,653</u>     | <u>10,968</u>    |
| Loss before income taxes<br>and equity in net earnings of subsidiaries ..... | (11,465)                       | (9,966)          | (10,887)         |
| Income tax benefit.....  | <u>(3,890)</u>                 | <u>(3,358)</u>   | <u>(4,131)</u>   |
| Loss before equity in net earnings of subsidiaries .....                     | (7,575)                        | (6,608)          | (6,756)          |
| Equity in net earnings of subsidiaries .....                                 | <u>84,848</u>                  | <u>62,921</u>    | <u>25,731</u>    |
| Net income .....   | <u>\$ 77,273</u>               | <u>\$ 56,313</u> | <u>\$ 18,975</u> |

See accompanying note to condensed financial statements.

See accompanying Report of Independent Registered Public Accounting Firm.

**HORACE MANN EDUCATORS CORPORATION**  
**(Parent Company Only)**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

|   | <u>Year Ended December 31,</u> |                 |                 |
|---|--------------------------------|-----------------|-----------------|
|   | <u>2005</u>                    | <u>2004</u>     | <u>2003</u>     |
| Cash flows – operating activities                             |                                |                 |                 |
| Interest expense paid .....                                   | \$ (8,275)                     | \$ (5,955)      | \$ (5,454)      |
| Contribution to defined benefit pension plan trust fund ..... | (4,514)                        | (3,500)         | (8,780)         |
| Federal income taxes recovered .....                          | 4,095                          | 7,153           | 6,344           |
| Cash dividends received from subsidiaries .....               | 23,000                         | 11,900          | 23,300          |
| Other, net .....  | <u>21,666</u>                  | <u>786</u>      | <u>2,534</u>    |
| Net cash provided by operating activities .....               | <u>35,972</u>                  | <u>10,384</u>   | <u>17,944</u>   |
| Cash flows - investing activities                             |                                |                 |                 |
| Net (increase) decrease in investments .....                  | 7                              | 6,635           | (3,368)         |
| Capital contributions to subsidiaries .....                   | <u>(21,000)</u>                | <u>-</u>        | <u>(27,500)</u> |
| Net cash provided by (used in) investing activities .....     | <u>(20,993)</u>                | <u>6,635</u>    | <u>(30,868)</u> |
| Cash flows - financing activities                             |                                |                 |                 |
| Dividends paid to shareholders .....                          | (18,226)                       | (17,978)        | (17,953)        |
| Principal borrowings (payments) on Bank Credit Facility ..... | (25,000)                       | -               | 25,000          |
| Exercise of stock options .....                               | 2,055                          | 1,592           | -               |
| Catastrophe-linked equity put option premium .....            | -                              | (1,125)         | (1,088)         |
| Proceeds from issuance<br>of Senior Notes due 2015 .....      | 74,245                         | -               | -               |
| Repurchase of Senior Notes due 2006 .....                     | (29,077)                       | -               | -               |
| Change in bank overdrafts .....                               | <u>(18,976)</u>                | <u>492</u>      | <u>6,965</u>    |
| Net cash provided by (used in) financing activities .....     | <u>(14,979)</u>                | <u>(17,019)</u> | <u>12,924</u>   |
| Net decrease in cash .....                                    | -                              | -               | -               |
| Cash at beginning of period .....                             | -                              | -               | -               |
| Cash at end of period .....                                   | <u>\$ -</u>                    | <u>\$ -</u>     | <u>\$ -</u>     |

See accompanying note to condensed financial statements.

See accompanying Report of Independent Registered Public Accounting Firm.

**HORACE MANN EDUCATORS CORPORATION  
(Parent Company Only)**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**NOTE TO CONDENSED FINANCIAL STATEMENTS**

The accompanying condensed financial statements should be read in conjunction with the Consolidated Financial Statements and the accompanying notes thereto.

See accompanying Report of Independent Registered Public Accounting Firm.

SCHEDULE III & VI (COMBINED)

HORACE MANN EDUCATORS CORPORATION

SCHEDULE III: SUPPLEMENTARY INSURANCE INFORMATION

SCHEDULE VI: SUPPLEMENTAL INFORMATION CONCERNING PROPERTY AND CASUALTY INSURANCE OPERATIONS

(Dollars in thousands)

| Column identification for<br>Schedule III: A<br>Schedule VI: A | B  | C   | D   | E  | F  | G                           | H  | I   | J   | K                              |   |                     |           |
|--|--|---|---|--|--|-----------------------------|--|---|---|--------------------------------|---|---------------------|-----------|
| Segment  | Deferred<br>policy<br>acquisition<br>costs | Future policy<br>benefits,<br>claims and<br>claims expenses | Discount,<br>if any,<br>deducted in<br>previous<br>column | Other<br>policy<br>claims and<br>benefits<br>payable | Premium<br>revenue/<br>premium<br>earned | Net<br>investment<br>income | Benefits,<br>claims<br>and<br>settlement<br>expenses | Claims and claims<br>adjustment expense<br>incurred related to<br>Current<br>year | Amortization<br>of deferred<br>policy<br>acquisition<br>costs | Other<br>operating<br>expenses | Paid<br>claims<br>and claims<br>adjustment<br>expense | Premiums<br>written |           |
| <b>Year Ended December 31, 2005</b>                            |  |   |   |  |  |                             |  |   |   |                                |   |                     |           |
| Property and casualty  | \$ 20,962                                  | \$ 342,662  | \$ 0  | \$ 193,506   | \$ 549,587                               | \$ 33,236                   | \$398,022  | \$411,122   | \$(13,100)  | \$57,202                       | \$ 69,576   | \$396,243           | \$546,949 |
| Annuity  | 116,311                                    | 1,821,828   | xxx   | 139,880  | 17,904                                   | 112,908                     | 82,292   | xxx   | xxx   | 6,340                          | 25,898  | xxx                 | xxx       |
| Life   | 96,357                                     | 805,973   | xxx   | 6,198  | 97,448                                   | 49,334                      | 78,264   | xxx   | xxx   | 7,921                          | 38,268  | xxx                 | xxx       |
| Other, including<br>consolidating eliminations                 | N/A  | -   | xxx   | N/A  | -  | (946)                       | -  | xxx   | xxx   | -                              | 11,585  | xxx                 | xxx       |
| Total  | \$233,630                                  | \$2,970,463   | xxx   | \$146,078  | \$664,939                                | \$194,632                   | \$558,578  | xxx   | xxx   | \$71,463                       | \$145,327   | xxx                 | xxx       |
| <b>Year Ended December 31, 2004</b>                            |  |   |   |  |  |                             |  |   |   |                                |   |                     |           |
| Property and casualty  | \$ 19,655                                  | \$ 335,000  | \$ 0  | \$ 196,144   | \$ 561,287                               | \$ 33,793                   | \$439,266  | \$435,451   | \$ 3,815  | \$56,141                       | \$ 70,208   | \$413,680           | \$562,327 |
| Annuity  | 95,986                                     | 1,690,580   | xxx   | 135,678  | 16,708                                   | 109,393                     | 76,876   | xxx   | xxx   | 4,364                          | 28,529  | xxx                 | xxx       |
| Life   | 93,935                                     | 780,282   | xxx   | 6,956  | 96,709                                   | 49,490                      | 76,936   | xxx   | xxx   | 9,496                          | 37,733  | xxx                 | xxx       |
| Other, including<br>consolidating eliminations                 | N/A  | -   | xxx   | N/A  | -  | (1,228)                     | -  | xxx   | xxx   | -                              | 9,043   | xxx                 | xxx       |
| Total  | \$209,576                                  | \$2,805,862   | xxx   | \$142,634  | \$674,704                                | \$191,448                   | \$593,078  | xxx   | xxx   | \$70,001                       | \$145,513   | xxx                 | xxx       |
| <b>Year Ended December 31, 2003</b>                            |  |   |   |  |  |                             |  |   |   |                                |   |                     |           |
| Property and casualty  | \$ 19,022                                  | \$ 304,307  | \$ 0  | \$ 190,204   | \$ 533,761                               | \$ 31,892                   | \$472,843  | \$416,473   | \$ 56,370   | \$56,904                       | \$ 71,078   | \$420,156           | \$546,510 |
| Annuity  | 80,469                                     | 1,528,516   | xxx   | 122,104  | 14,588                                   | 104,380                     | 72,076   | xxx   | xxx   | 767                            | 26,359  | xxx                 | xxx       |
| Life   | 94,212                                     | 755,216   | xxx   | 7,784  | 96,004                                   | 49,605                      | 77,029   | xxx   | xxx   | 7,491                          | 40,313  | xxx                 | xxx       |
| Other, including<br>consolidating eliminations                 | N/A  | -   | xxx   | N/A  | (817)                                    | (1,152)                     | -  | xxx   | xxx   | (817)                          | 10,526  | xxx                 | xxx       |
| Total  | \$193,703                                  | \$2,588,039   | xxx   | \$129,888  | \$643,536                                | \$184,725                   | \$621,948  | xxx   | xxx   | \$64,345                       | \$148,276   | xxx                 | xxx       |

N/A Not applicable.

See accompanying Report of Independent Registered Public Accounting Firm.

## HORACE MANN EDUCATORS CORPORATION

## REINSURANCE

(Dollars in thousands)

| <u>Column A</u>                                   | <u>Column B</u>         | <u>Column C</u>                         | <u>Column D</u>                             | <u>Column E</u>   | <u>Column F</u>                                    |
|---|-------------------------|---|---|-------------------|--|
|   | <u>Gross<br/>Amount</u> | <u>Ceded to<br/>Other<br/>Companies</u> | <u>Assumed<br/>from Other<br/>Companies</u> | <u>Net</u>        | <u>Percentage<br/>of Amount<br/>Assumed to Net</u> |
| <b>Year ended December 31, 2005</b>               |                         |   |   |                   |  |
| Life insurance in force.....                      | \$13,142,164            | \$1,553,610                             | -   | \$11,588,554      | -  |
| Premiums  |                         |   |   |                   |  |
| Property and casualty.....                        | \$ 568,274              | \$ 31,432                               | \$12,745                                    | \$ 549,587        | 2.3%   |
| Annuity.....                                      | 17,904                  | -                                       | -   | 17,904            | -  |
| Life.....   | 102,354                 | 4,906                                   | -   | 97,448            | -  |
| Other, including<br>consolidating eliminations... | -                       | -                                       | -   | -                 | -  |
| Total premiums.....                               | <u>\$ 688,532</u>       | <u>\$ 36,338</u>                        | <u>\$12,745</u>                             | <u>\$ 664,939</u> | 1.9%   |
| <b>Year ended December 31, 2004</b>               |                         |   |   |                   |  |
| Life insurance in force.....                      | \$13,223,226            | \$1,428,621                             | -   | \$11,794,605      | -  |
| Premiums  |                         |   |   |                   |  |
| Property and casualty.....                        | \$ 567,923              | \$ 26,126                               | \$19,490                                    | \$ 561,287        | 3.5%   |
| Annuity.....                                      | 16,708                  | -                                       | -   | 16,708            | -  |
| Life.....   | 102,101                 | 5,392                                   | -   | 96,709            | -  |
| Other, including<br>consolidating eliminations... | -                       | -                                       | -   | -                 | -  |
| Total premiums.....                               | <u>\$ 686,732</u>       | <u>\$ 31,518</u>                        | <u>\$19,490</u>                             | <u>\$ 674,704</u> | 2.9%   |
| <b>Year ended December 31, 2003</b>               |                         |   |   |                   |  |
| Life insurance in force.....                      | \$13,263,273            | \$1,333,005                             | -   | \$11,930,268      | -  |
| Premiums  |                         |   |   |                   |  |
| Property and casualty.....                        | \$ 542,500              | \$ 16,353                               | \$ 7,614                                    | \$ 533,761        | 1.4%   |
| Annuity.....                                      | 14,588                  | -                                       | -   | 14,588            | -  |
| Life.....   | 101,900                 | 5,896                                   | -   | 96,004            | -  |
| Other, including<br>consolidating eliminations... | (817)                   | -                                       | -   | (817)             | -  |
| Total premiums.....                               | <u>\$ 658,171</u>       | <u>\$ 22,249</u>                        | <u>\$ 7,614</u>                             | <u>\$ 643,536</u> | 1.2%   |

NOTE: Premiums above include insurance premiums earned and contract charges earned.

See accompanying Report of Independent Registered Public Accounting Firm.

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## Directors

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**Joseph J. Melone**

Chairman of the Board of Directors  
Horace Mann Educators Corporation  
President & Chief Executive Officer (retired)  
The Equitable Companies Inc.

**Louis G. Lower II**

President & Chief Executive Officer  
Horace Mann Educators Corporation

**William W. Abbott**

Senior Vice President (retired)  
Procter & Gamble

**Dr. Mary H. Futrell**

Dean, Graduate School of  
Education and Human Development  
The George Washington University

**Stephen J. Hasenmiller\***

Senior Vice President (retired)  
The Hartford Financial Services Group, Inc.

**Jeffrey L. Morby\***

Managing Director  
Amarna Corporation, LLC

**Shaun F. O'Malley\***

Chairman Emeritus  
Price Waterhouse LLP

**Charles A. Parker\***

Financial Consultant

\*Member of the Audit Committee, each an independent director.

## Officers

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**Louis G. Lower II**

President & Chief Executive Officer

**Peter H. Heckman**

Executive Vice President  
Chief Financial Officer

**Douglas W. Reynolds**

Executive Vice President  
Property & Casualty  
and Information Technology

**Paul D. Andrews**

Senior Vice President  
Corporate Services

**Dennis E. Bianchi**

Senior Vice President  
Property & Casualty Claims

**Bret A. Conklin**

Senior Vice President  
Controller

**Frank D'Ambra III**

Senior Vice President  
Life & Annuity

**Dwayne D. Hallman**

Senior Vice President  
Finance

**Robert B. Joyner**

Senior Vice President  
Marketing

**Richard V. Atkinson**

Vice President & Chief Actuary  
Property & Casualty

**Ann M. Caparrós**

General Counsel & Chief  
Compliance Officer  
Corporate Secretary

**Angela S. Christian**

Vice President & Treasurer

**Deborah F. Kretchmar**

Vice President & Audit Director

**Robert E. Rich**

Vice President & Chief Actuary  
Life & Annuity

In November 1991, Horace Mann Educators Corporation completed an initial public offering of its common stock at a price of \$9 per share. The Company's common stock is traded on the New York Stock Exchange under the symbol HMN. The following table sets forth the high and low sales prices and the cash dividends paid per share during the periods indicated.

| Fiscal Period  | Market Price |          | Dividend Paid |
|----------------|--------------|----------|---------------|
|                | High         | Low      |               |
| <b>2005</b>    |              |          |               |
| Fourth Quarter | \$ 20.04     | \$ 17.96 | \$ 0.105      |
| Third Quarter  | 20.80        | 18.90    | 0.105         |
| Second Quarter | 19.00        | 15.86    | 0.105         |
| First Quarter  | 19.20        | 17.31    | 0.105         |
| <b>2004</b>    |              |          |               |
| Fourth Quarter | \$ 19.30     | \$ 16.01 | \$ 0.105      |
| Third Quarter  | 17.59        | 15.83    | 0.105         |
| Second Quarter | 17.48        | 14.92    | 0.105         |
| First Quarter  | 16.10        | 13.94    | 0.105         |

## Corporate Data

### Corporate Office

1 Horace Mann Plaza  
Springfield, IL 62715-0001  
Telephone: (217) 789-2500  
Internet: [www.horacemann.com](http://www.horacemann.com)  
[www.reacheverychild.com](http://www.reacheverychild.com)

### Annual Meeting

May 24, 2006  
9:00 a.m.  
President Abraham Lincoln  
Hotel and Conference Center  
701 East Adams Street  
Springfield, IL 62701

### Independent Accountants

KPMG LLP  
303 East Wacker Drive  
Chicago, IL 60601

### Common Stock

HMEC Stock is traded on the NYSE (HMN)

### Transfer Agent

American Stock Transfer & Trust Company  
59 Maiden Lane  
New York, NY 10038

### Senior Convertible Notes

HMEC senior convertible notes are traded in the open market (HMN 1.425)

### Senior Notes

HMEC senior notes are traded in the open market (HMN 6.05)

### Additional Information

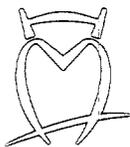
Additional financial data on HMEC and its subsidiaries is included in Form 10-K filed with the Securities and Exchange Commission. Electronic copies of HMEC's SEC filings are available at [www.horacemann.com](http://www.horacemann.com). Printed copies of SEC filings are available upon written request from:

### Investor Relations

Horace Mann  
Educators Corporation  
1 Horace Mann Plaza, C-120  
Springfield, IL 62715-0001

## The Horace Mann Value Proposition

Provide lifelong  
financial well-being for  
educators and their  
families through  
personalized service,  
advice and a full  
range of tailored insurance  
and financial products.



Horace Mann®  
Educated Financial Solutions