

**GAINSCO INC. AND SUBSIDIARIES**

Consolidated Financial Statements

December 31, 2017 and 2016

(With Independent Auditor's Report Thereon)



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## **Independent Auditor's Report**

The Board of Directors  
GAINSCO, INC.  
Dallas, Texas

We have audited the accompanying consolidated financial statements of GAINSCO, INC. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



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### *Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of GAINSCO, INC. and its subsidiaries as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*BDO USA, LLP*

Dallas, Texas  
May 3, 2018

**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Balance Sheets

December 31, 2017 and 2016

(Amounts in thousands, except share data)

<u>Assets</u>	<u>2017</u>	<u>2016</u>
Investments (notes 1, 2 and 3):		
Bonds, available for sale – at fair value (amortized cost: \$181,235 – 2017, \$158,753 – 2016)	\$ 180,364	156,329
Preferred stocks, available for sale – at fair value (cost: \$8,372 – 2017, \$4,798 – 2016)	8,682	5,107
Common stocks, available for sale – at fair value (cost: \$9,568 – 2017, \$5,988 – 2016)	11,650	5,029
Certificates of deposit – at cost, which approximates fair value (amortized cost: \$100 – 2017 and 2016)	100	100
Other long-term investments –equity method (which approximates cost)	12,368	12,943
Short-term investments – at fair value (amortized cost: \$46,395 – 2017, \$40,937 – 2016)	<u>46,375</u>	<u>40,922</u>
Total investments	259,539	220,430
Cash	962	826
Accrued investment income (note 1)	1,767	1,651
Premiums receivable (net of allowance for doubtful accounts: \$1,063 – 2017, \$980 – 2016) (note 1)	67,164	55,762
Finance receivables (net of allowance for doubtful accounts: \$0 – 2017 and 2016) (note 1)	1,546	2,119
Deferred policy acquisition costs (note 1)	12,079	9,562
Ceded unpaid claims and claim adjustment expenses (notes 1 and 8)	57	-
Property and equipment (net of accumulated depreciation and amortization: \$15,430 – 2017, \$14,104 – 2016) (notes 1 and 4)	12,674	11,947
Auto vehicle inventory (notes 1 and 5)	9,959	8,140
Deferred Federal income taxes (notes 1 and 6)	2,976	9,605
Other assets	3,589	3,070
Intangible assets (notes 1 and 7)	2,993	2,993
Goodwill – insurance operations (notes 1 and 7)	<u>609</u>	<u>609</u>
Total assets	\$ <u>375,914</u>	<u>326,714</u>

(Continued)

**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Balance Sheets

December 31, 2017 and 2016

(Amounts in thousands, except share data)

<u>Liabilities and Shareholders' Equity</u>	<u>2017</u>	<u>2016</u>
<b>Liabilities:</b>		
Unpaid claims and claim adjustment expenses (notes 1 and 8)	\$ 94,487	83,575
Unearned premiums (note 1)	77,617	64,432
Accounts payable	18,869	14,368
Vehicle floor plan payable (notes 1 and 5)	10,060	7,769
Subordinated debentures (note 11)	43,000	43,000
Mortgage loan payable (note 12)	5,041	5,325
Current Federal income taxes (notes 1 and 6)	1,842	372
Other liabilities	13,484	9,219
Cash overdraft	<u>4,112</u>	<u>1,588</u>
Total liabilities	268,512	229,648
Commitments and contingencies (notes 5, 9, 10, 11, 12, 15, 16 and 17)		
<b>Shareholders' Equity (notes 13 and 14):</b>		
Common stock (\$.10 par value, 12,500,000 shares authorized, 5,560,232 shares issued and 5,078,114 shares outstanding at December 31, 2017, 5,384,232 shares issued and 4,902,114 shares outstanding at December 31, 2016)	556	538
Additional paid-in capital	121,673	126,272
Accumulated deficit	(8,482)	(20,174)
Accumulated other comprehensive loss (notes 2 and 3)	1,186	(2,039)
Treasury stock, at cost (482,118 shares at December 31, 2017 and 2016) (notes 1 and 13)	<u>(7,531)</u>	<u>(7,531)</u>
Total shareholders' equity	<u>107,402</u>	<u>97,066</u>
Total liabilities and shareholders' equity	\$ <u>375,914</u>	<u>326,714</u>

See accompanying notes to consolidated financial statements.

**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Statements of Operations

Years ended December 31, 2017 and 2016

(Amounts in thousands, except per share data)

	2017	2016
<b>Revenues:</b>		
Net premiums earned (notes 1 and 9)	\$ 274,041	238,034
Net investment income (note 2)	6,831	6,640
Realized investment gains (losses) (note 2 and 3), net:		
Other-than-temporary impairment losses	-	(117)
Other realized investment gains, net	<u>531</u>	<u>10,652</u>
Total realized investment gains, net	<u>531</u>	<u>10,535</u>
Agency revenues (note 1)	12,643	11,872
Gross auto sales (note 1)	39,450	34,325
Other revenue, net (note 1)	<u>764</u>	<u>874</u>
Total revenues	<u>334,260</u>	<u>302,280</u>
<b>Expenses:</b>		
Claims and claim adjustment expenses (notes 1, 8 and 9)	179,181	166,037
Policy acquisition costs (note 1)	39,364	34,240
Underwriting and operating expenses	56,599	50,883
Cost of auto sales (note 1)	35,744	30,431
Interest expense, net (notes 10 and 11)	<u>2,422</u>	<u>2,223</u>
Total expenses	<u>313,310</u>	<u>283,814</u>
Income before Federal income taxes	20,950	18,466
<b>Federal income taxes (notes 1 and 6):</b>		
Current expense	3,994	716
Deferred expense	<u>5,264</u>	<u>5,759</u>
Total income tax expense	<u>9,258</u>	<u>6,475</u>
Net income	\$ <u>11,692</u>	<u>11,991</u>
<b>Income per common share (notes 1, 13 and 14):</b>		
Basic	\$ <u>2.34</u>	<u>2.45</u>
Diluted	\$ <u>2.34</u>	<u>2.45</u>
<b>Weighted average common shares outstanding (notes 13 and 14):</b>		
Basic	<u>5,005</u>	<u>4,887</u>
Diluted	<u>5,005</u>	<u>4,887</u>

See accompanying notes to consolidated financial statements.

## GAINSCO, INC. AND SUBSIDIARIES

### Consolidated Statements of Comprehensive Income

Years ended December 31, 2017 and 2016

(Amounts in thousands)

	<u>2017</u>	<u>2016</u>
Net income	\$ <u>11,692</u>	<u>11,991</u>
Other comprehensive income before tax:		
Unrealized gains on investments:		
Unrealized holding gains arising during the period	5,121	12,095
Less: Reclassification adjustments for realized gains included in net income	<u>(531)</u>	<u>(10,535)</u>
Unrealized gains on investments, net	<u>4,590</u>	<u>1,560</u>
Other comprehensive income, before tax	\$ 4,590	1,560
Income tax expense related to components of other comprehensive income	<u>(1,365)</u>	<u>530</u>
Other comprehensive income, net of tax	<u>3,225</u>	<u>1,030</u>
Comprehensive income	\$ <u>14,917</u>	<u>13,021</u>

See accompanying notes to consolidated financial statements.

**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Statements of Shareholders' Equity

Years ended December 31, 2017 and 2016

(Amounts in thousands)

		2017	2016
<b>Common Stock:</b>			
Balance at beginning of year	\$	538	534
Stock issuance		<u>18</u>	<u>4</u>
Balance at end of year	\$	<u>556</u>	<u>538</u>
<b>Additional paid-in capital:</b>			
Balance at beginning of year	\$	126,272	137,908
Shareholder dividend		(7,617)	(12,267)
Stock issuance		(18)	(4)
Stock-based compensation expense		<u>3,036</u>	<u>635</u>
Balance at end of year	\$	<u>121,673</u>	<u>126,272</u>
<b>Accumulated deficit:</b>			
Balance at beginning of year	\$	(20,174)	(32,165)
Net income		<u>11,692</u>	<u>11,991</u>
Balance at end of year	\$	<u>(8,482)</u>	<u>(20,174)</u>
<b>Accumulated other comprehensive loss:</b>			
Balance at beginning of year	\$	(2,039)	(3,069)
Other comprehensive income		<u>3,225</u>	<u>1,030</u>
Balance at end of year	\$	<u>1,186</u>	<u>(2,039)</u>
<b>Treasury stock:</b>			
Balance at beginning of year	\$	(7,531)	(7,468)
Stock repurchase		<u>-</u>	<u>(63)</u>
Balance at end of year		<u>(7,531)</u>	<u>(7,531)</u>
<b>Total shareholders' equity end of year</b>	<b>\$</b>	<b><u>107,402</u></b>	<b><u>97,066</u></b>

See accompanying notes to consolidated financial statements.



**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Statements of Cash Flows

Years ended December 31, 2017 and 2016

(Amounts in thousands)

	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:		
Net income	\$ 11,692	11,991
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	4,838	5,066
Impairment of intangible assets	-	2,047
Other-than-temporary impairment of investments	-	117
Non-cash compensation expense	3,036	635
Realized gains (excluding other-than-temporary impairments)	(531)	(10,652)
Loss on sale of property and equipment	321	131
Deferred Federal income tax expense	5,264	5,759
Changes in operating assets and liabilities, net of assets acquired:		
Accrued investment income	(116)	96
Premiums receivable	(11,402)	(2,291)
Finance receivables	573	186
Ceded unpaid claims and claim adjustment expenses	(57)	-
Deferred policy acquisition costs	(2,517)	(230)
Auto vehicle inventory	(1,819)	895
Other assets	(591)	63
Unpaid claims and claim adjustment expenses	10,912	(4,089)
Unearned premiums	13,185	2,238
Accounts payable	4,501	1,799
Other liabilities	4,265	1,762
Current Federal income taxes	<u>1,470</u>	<u>241</u>
Net cash provided by operating activities	\$ <u>43,024</u>	<u>15,764</u>

(Continued)

**GAINSCO, INC. AND SUBSIDIARIES**

Consolidated Statements of Cash Flows

Years ended December 31, 2017 and 2016

(Amounts in thousands)

	<u>2017</u>	<u>2016</u>
Cash flows from investing activities:		
Bonds available for sale:		
Sold	\$ 19,827	32,191
Matured	18,536	23,329
Purchased	(62,823)	(51,237)
Certificates of deposit:		
Matured	100	100
Purchased	(100)	(100)
Preferred stocks sold	1,697	-
Preferred stocks purchased	(5,290)	(3,853)
Common stocks sold	73	8,111
Common stocks purchased	(3,580)	-
Other long-term investments sold	1,346	295
Other long-term investments purchased	-	(122)
Net change in short-term investments	(5,783)	(1,933)
Property and equipment sold	(321)	(131)
Property and equipment purchased	<u>(3,484)</u>	<u>(1,856)</u>
Net cash (used in) provided by investing activities	<u>(39,802)</u>	<u>4,794</u>
Cash flows from financing activities:		
Principal payment on note	(3,000)	(3,640)
Draw on note payable	3,000	2,000
Proceeds from floor plan financing	32,089	25,298
Repayments on floor plan financing	(29,798)	(26,270)
Principal payment on mortgage loan	(284)	(284)
Purchase of treasury shares	-	(63)
Shareholder dividend	(7,617)	(12,267)
Net change in cash overdraft	<u>2,524</u>	<u>(6,221)</u>
Net cash used in financing activities	<u>(3,086)</u>	<u>(21,447)</u>
Net decrease increase in cash	136	(889)
Cash at beginning of year	<u>826</u>	<u>1,715</u>
Cash at end of year	\$ <u><u>962</u></u>	\$ <u><u>826</u></u>

Supplemental disclosures of cash flow information:

\$2,454 and \$2,272 in interest was paid during 2017 and 2016, respectively (notes 10 and 11).

\$2,527 and \$492 in income tax payments were made during 2017 and 2016, respectively (note 6).

See accompanying notes to consolidated financial statements.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

#### (1) Background and Summary of Significant Accounting Policies

##### (a) *Basis of Consolidation*

The accompanying consolidated financial statements include the accounts of GAINSCO, INC. (“GANS,” “our,” “us” or “we”) and its wholly-owned subsidiaries (collectively, the “Company” or “we”), MGA Insurance Company, Inc. (“MGA”), National Specialty Lines, Inc. (“NSL”), BSAG, Inc., Bob Stallings Car Rental, Inc., First Win Automotive, Inc., GAINSCO Automotive Holdings Corp., Stallings Auto Group, Inc. (“SAG”), Bob Stallings Hyundai, Inc. (“BSHI”), Red Dragon Properties I, Inc. (collectively, the “Auto Group”), GAINSCO Service Corp., GAINSCO/Bob Stallings Racing, Inc. and GAINSCO Auto Insurance Agency, Inc. MGA has one wholly owned subsidiary, MGA Agency, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial statements included herein have been prepared by GANS, on the basis of accounting principles generally accepted in the United States (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

##### (b) *Nature of Operations*

The Company’s nonstandard personal auto products are primarily aligned with customers seeking to purchase basic coverage and limits of liability required by statutory requirements, or slightly higher. Our products include coverage for third party liability, for bodily injury and property damage, as well as collision and comprehensive coverage for theft, physical damage and other perils for an insured’s vehicle. Within this context, we offer our products to a wide range of customers who present varying degrees of potential risk to the Company, and we strive to price our products to reflect this range of risk accordingly, in order to earn an underwriting profit. Simultaneously, when actuarially prudent, we attempt to position our product pricing to be competitive with other companies offering similar products to optimize our likelihood of securing our targeted customers. We offer flexible premium down payment, installment payment, late payment, and policy reinstatement plans that we believe help us secure new customers and retain existing customers, while generating an additional source of income from fees that we charge for those services. We primarily write six-month policies in Arizona, New Mexico, Oklahoma, Texas and Utah, with both six month and one year policies in Florida, Georgia, South Carolina, Tennessee and Virginia. The terms of policies we are permitted to offer varies in the states in which we operate.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

GANS expects to use cash during the next twelve months primarily for: (1) interest on the Subordinated debentures and the credit agreement, (2) administrative expenses and (3) investments. The primary sources of cash to meet these obligations are assets held by GANS, dividends from its subsidiaries and the ability to draw from its \$20.0 million bank credit agreement that was renewed in December 2016 and now has a maturity date of December 2018. GANS believes the cash available from its short-term investments, dividends from its subsidiaries and advances from its \$20.0 million bank credit agreement should be sufficient to meet its expected obligations for the next twelve months.

(c) ***Investments***

The Company did not hold any held-to-maturity investment securities during 2017 and 2016. Investments classified as available-for-sale securities include debt and equity securities that are not classified as held-to-maturity or as trading security investments and are carried at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely, "Other Comprehensive Income." Other long-term investments in partnerships or limited liability companies are recorded under the equity method of accounting, which approximates cost. Under the equity method, the investment, originally recorded at cost, is adjusted to recognize our share of the net earnings or losses as they occur.

Investments are stated at fair value and are based on prices quoted in the most active market for each security, the fair value of comparable securities, discounted cash flow models or similar methods. Premiums and discounts on mortgage-backed and asset-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations. The most significant determinants of prepayments are the difference between interest rates on the underlying mortgages, or underlying securities, and the current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties and the credit worthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

Investment securities are exposed to a number of factors, including general economic and business environment, changes in the credit quality of the issuer of the fixed income securities, changes in market conditions or disruptions in particular markets, changes in interest rates, or regulatory changes. Fair values of securities fluctuate based on the magnitude of changing market conditions. The Company's securities are issued by domestic entities and are backed either by collateral or the credit of the underlying issuer. Factors such as an economic downturn, disruptions in the credit markets, a regulatory change pertaining to the issuer's industry, deterioration in the cash flows or the quality of assets of the issuer, or a change in the issuer's marketplace may adversely affect the

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Company's ability to collect principal and interest from the issuer. Both equity and fixed income securities have been affected over the past several years, and may be affected in the future, by significant external events. Credit rating downgrades, defaults, and impairments may result in write-downs in the value of the investment securities held by the Company. The Company regularly monitors its portfolio for pricing changes, which might indicate potential impairments, and performs reviews of securities with unrealized losses. In such cases, changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial conditions, business prospects or other factors, or (ii) market-related factors, such as interest rates. When a security in the Company's investment portfolio has an unrealized loss in fair value that is deemed to be other than temporary, the Company reduces the book value of such security to its current fair value, recognizing the credit related decline as a realized loss in the Consolidated Statements of Operations and a revised GAAP cost basis for the security is established.

For fixed maturity securities that are other-than-temporarily impaired, the Company assesses its intent to sell and the likelihood of being required to sell the security before recovery of its amortized cost. If a fixed maturity security is considered other-than-temporarily impaired ("OTTI"), but the Company does not intend to and is not more than likely to be required to sell the security prior to its recovery to amortized cost, the amount of the impairment is separated into a credit loss component and the amount due to all other factors. The credit loss component of an impairment charge on a fixed maturity security is determined by the excess of the amortized cost over the present value of the expected cash flows. The present value is determined using the best estimate of cash flows discounted at (1) the effective interest rate implicit at the date of acquisition for non-structured securities or (2) the book yield for structured securities. The techniques and assumptions for determining the best estimate of cash flows varies depending on the type of security. The credit loss component of an impairment charge is recognized in net earnings while the non-credit component is recognized in accumulated other comprehensive loss, a component of shareholders' equity.

Accrued investment income is the interest earned on securities which has been recognized in the results of operations, but the cash has not been received from the various security issuers. This accrual is based on the terms of each of the various securities and uses the 'effective interest method' for amortizing the premium and accruing the discount. Realized gains (losses) on securities are computed based upon the "specific identification" method on trade date and includes write-downs on securities considered to have other than temporary declines in fair value. Dividends on preferred and common stocks are recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

**(d) *Deferred Policy Acquisition Costs and Policy Acquisition Costs***

Deferred policy acquisition costs (“DAC”) are principally commissions, premium taxes and underwriting expenses which are deferred. With the adoption of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, in 2012, the Company defers direct incremental costs associated with successful insurance contract acquisitions. Policy acquisition costs are principally commissions, premium taxes, marketing and underwriting expenses and the change in deferred policy acquisition costs that are charged to operations over the period in which the related premiums are earned. The Company utilizes investment income when assessing recoverability of deferred policy acquisition costs. A premium deficiency and a corresponding charge to income is recognized if the sum of the expected claims and claim adjustment expenses (“CAE”), unamortized acquisition costs and maintenance costs exceeds related unearned premiums and anticipated investment income. At December 31, 2017 and 2016, there was no premium deficiency that was required to be recognized.

Information relating to these net deferred amounts, as of and for the years ended December 31, 2017 and 2016 is summarized as follows:

	<u>2017</u>	<u>2016</u>
	(Amounts in thousands)	
Asset balance, beginning of period	\$ <u>9,562</u>	<u>9,332</u>
Deferred commissions	32,971	26,914
Deferred premium taxes and marketing expenses	9,777	7,550
Amortization	<u>(40,232)</u>	<u>(34,234)</u>
Net change	<u>2,516</u>	<u>230</u>
Asset balance, end of period	\$ <u>12,078</u>	<u>9,562</u>

**(e) *Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets (leasehold improvements are amortized over the terms of the lease and primarily three years for furniture and equipment). Computer software costs relating to programs for internal use are recorded in property and equipment and are amortized using the straight-line method over three years or the estimated useful life, whichever is longer.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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Costs associated with software developed or purchased for internal use are capitalized based on FASB ASC 350-40, *Intangibles – Goodwill and Other – Internal-use Software*, and other related guidance. Capitalized costs include external direct costs of materials and services consumed in developing or obtaining internal-use software. Costs incurred in development and enhancement of software that do not meet the capitalization criteria, such as costs of activities performed during the preliminary and post-implementation stages, are expensed as incurred. The Company reviews any impairment of the capitalized costs on a periodic basis. The Company amortizes such costs over the estimated useful life of the software, which is three years once the software has been placed in service.

**(f) *Auto Vehicle Inventory***

Auto vehicle inventory consists of new, used and demonstrator automobiles sold to consumers. Vehicles acquired are carried at lower of cost-or-market. Cost is computed as amortized cost less manufacturer incentives.

**(g) *Federal Income Taxes***

The Company and its subsidiaries file a consolidated Federal income tax return. Deferred income tax items are accounted for under the “asset and liability” method which provides for temporary differences between the reporting of earnings for financial statement purposes and for tax purposes, primarily deferred policy acquisition costs, the discount on unpaid claims and claim adjustment expenses, net operating loss carryforwards and the nondeductible portion of the change in unearned premiums. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment dates.

The Company currently has no valuation allowance for any temporary differences. ASC 740-10, *Income Taxes – Overall* (“ASC 740-10”) requires positive evidence, such as cumulative taxable income over the most recent three-year period and other available objective and subjective evidence, for management to conclude that it is “more likely than not” that a portion or all of the deferred tax assets will be realized. While both objective and subjective evidence are considered, it is the Company’s understanding that objective evidence should generally be given more weight in the analysis under ASC 740-10. In making the determination, the Company considered all available evidence, including the fact that the Company generated cumulative taxable income for the three years ended December 31, 2017. The Company does not record a tax valuation allowance relating to the tax effect of net unrealized losses on investments, excluding equity securities, because it is more likely than not that these losses would reverse or be utilized in future periods. The Company has the ability and it is the Company’s intent to

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

fully recover the principal, which could require the Company to hold these securities until their maturity; therefore, the Company considers the impairment to be temporary – see note 6.

We recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which we expect to recover or settle those temporary differences. Should a change in tax rates occur, we recognize the effect on deferred tax assets and liabilities in operations in the period that includes the enactment date. We reflected the impact of the Tax Cuts and Jobs Act (2017 Tax Act) in the fourth quarter of 2017, the period when the legislation was enacted.

The Company previously adopted the provisions of ASC 740, *Income Taxes – Overall – Transition and Open Effective Date Information* (“ASC 740-10-65”). At December 31, 2017, the Company has not identified any material uncertain tax positions in accordance with ASC 740-10-25. The Company is subject to U.S. federal income tax examinations by tax authorities for 2001 and subsequent years.

#### **(h) Goodwill and Intangible Assets**

The excess of the purchase price of NSL over the fair value of net tangible assets acquired was recorded as goodwill, and was attributed to the Southeast Region reporting unit.

The excess of the purchase price of the acquired net tangible assets from the Hyundai auto dealership by the Company’s subsidiary, SAG, is recorded as intangible assets and was attributed to the Auto Group reporting unit subject to an annual impairment test.

In accordance with ASC 350-20, *Intangibles – Goodwill and Other – Goodwill*, goodwill is not amortized but rather is subject to a qualitative assessment of events or factors to determine if the annual two-step test of goodwill impairment to be performed. We performed our annual goodwill impairment testing as of December 31 for the reporting units. Under the first step, if the fair value of any reporting unit is less than the carrying value, an indication goodwill impairment exists for the reporting unit and the enterprise must perform step two of the impairment test. In the second step, we compare the goodwill amount reflected in the balance sheet to the implied fair value of the reporting unit's goodwill.



## GAINSCO, INC. AND SUBSIDIARIES

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The implied fair value of the goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a variety of methods, including a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed.

(i) *Claims and Claim Adjustment Expenses*

An insurance company generally makes claim payments as a result of accidents involving the risks insured under the insurance policies it issues. Months and sometimes years may elapse between the occurrence of an accident, reporting of the accident to the insurer and payment of the claim. Insurers record a liability for estimates of claims that will be paid for accidents reported to them, which are referred to as “case reserves.” In addition, because accidents are not always reported promptly upon occurrence and because the assessment of existing known claims may change over time with the development of new facts, circumstances and conditions, insurers estimate liabilities for such items, which are referred to as incurred but not reported (“IBNR”) reserves.

The Company establishes claims and claim adjustment expense (“CAE”) reserves that are estimates of amounts needed to pay claims and related expenses in the future for insured events that have already occurred. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain.

Claims and CAE reserves are typically comprised of (1) case reserves for claims reported and (2) IBNR reserves, which include a provision for expected future development on case reserves and for losses that have occurred but for which claims have not yet been reported. Case reserves are estimated based on the experience and knowledge of claims staff regarding the nature and potential cost of each claim and are adjusted as additional information becomes known or payments are made. Actuaries estimate ultimate Claims and CAE using various generally accepted actuarial methods applied to known losses and other relevant information. IBNR reserves are the difference between estimates of ultimate Claims and CAE and case incurred Claims and CAE. Like case reserves, IBNR reserves are adjusted as additional information becomes known or payments are made.

## GAINSCO, INC. AND SUBSIDIARIES

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Ultimate claims and CAE are generally determined by extrapolation of claim emergence and settlement patterns observed in the past that can reasonably be expected to persist into the future. In forecasting ultimate claims and CAE with respect to any line of business, past experience with respect to that line of business is the primary resource, but cannot be relied upon in isolation. The Company's own experience, particularly claims development experience, such as trends in case reserves, payments on and closings of claims, as well as changes in business mix and coverage limits, is the most important information for estimating its reserves. External data, available from organizations such as statistical bureaus, consulting firms and reinsurance companies, is sometimes used to supplement or corroborate management's own experience.

Uncertainties in estimating ultimate claims and CAE are magnified by the time lag between when a claim actually occurs and when it is reported and eventually settled. If management determines that an adjustment is appropriate, the adjustment is booked in the accounting period in which such determination is made. Accordingly, should reserves need to be increased or decreased in the future from amounts currently established, future results of operations would be negatively or positively impacted.

The Company's actuary uses several generally accepted actuarial methods to evaluate its Claims and CAE reserves, each of which has its own strengths and weaknesses. Management places more or less reliance on a particular method based on the facts and circumstances at the time the reserve estimates are made. These methods generally fall into one of the following categories or are hybrids of one or more of the following categories:

- Historical paid Claims and CAE development methods – These methods use historical Claims and CAE payments over discrete periods of time to estimate future Claims and CAE. Historical paid Claims and CAE development methods assume that the ratio of Claims and CAE paid in one period to Claims and CAE paid in an earlier period will remain constant.
- Historical incurred Claims and CAE development methods – These methods, like historical paid Claims and CAE development methods, assume that the ratio of Claims and CAE in one period to Claims and CAE in an earlier period will remain constant in the future. However, instead of using paid Claims and CAE, these methods use incurred Claims and CAE (i.e., the sum of cumulative historical Claims and CAE payments plus outstanding case reserves) over discrete periods of time to estimate future Claims and CAE.
- Expected Claims and CAE ratio methods – These methods are based on the assumption that ultimate Claims and CAE vary proportionately with premiums. Expected Claims and CAE ratios are typically developed based upon the information used in pricing, and are multiplied by the total amount of premiums earned to calculate ultimate Claims and CAE.

## GAINSCO, INC. AND SUBSIDIARIES

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- Bornhuetter-Ferguson methods – These methods are a blend of the expected Claims and CAE ratio and Claims and CAE development methods. The percent of incurred (or paid) Claims and CAE to ultimate Claims and CAE implied by the selected development pattern from the incurred (or paid) Claims and CAE development method is used to determine the percentage of ultimate Claims and CAE yet to be developed.

The Company performs an actuarial review of its recorded reserves each quarter. As part of that review, the Company's actuary compares the previous quarter's projections of incurred, paid and case reserve activity, including amounts incurred but not reported, to amounts experienced in the quarter. Differences between previous estimates and actual experience are evaluated to determine whether a given actuarial method for estimating claims and CAE should be relied upon to a greater or lesser extent than it had been in the past. While some variance is expected each quarter due to the inherent uncertainty in claims and CAE, persistent or large variances would indicate that prior assumptions and/or reliance on certain reserving methods may need to be revised going forward. Upon completion of each quarterly review, the carried reserves are booked to the reserve levels as indicated by the Company's actuary.

The process of establishing claims reserves is imprecise and reflects significant judgmental factors. In many liability cases, significant periods of time, ranging up to several years or more, may elapse between the occurrence of an insured claim and the settlement of the claim. The actual emergence of claims and CAE may vary, perhaps materially, from the Company's estimates thereof, because (a) estimates of liabilities are subject to large potential revisions, as the ultimate disposition of claims incurred prior to the financial statement date, whether reported or not, is subject to the outcome of events that have not yet occurred (e.g., jury decisions, court interpretations, legislative changes (even after coverage is written and reserves are initially set) that broaden liability and policy definitions and increase the severity of claims obligations, changes in the medical condition of claimants, public attitudes and social/economic conditions such as inflation), (b) estimates of claims do not make provision for extraordinary future emergence of new classes of claims or types of claims not sufficiently represented in the Company's historical data base or which are not yet quantifiable, and (c) estimates of future costs are subject to the inherent limitation on the ability to predict the aggregate course of future events.

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As the underlying processes require the use of estimates and professional actuarial judgment, establishing claims reserves is an inherently uncertain process. As our experience develops and we learn new information, our quarterly reserving process may produce revisions to our previously reported claims reserves, which we refer to as “development,” and such changes may be material. We recognize favorable development when we decrease our previous estimate of ultimate losses, which results in an increase in net income in the period recognized. We recognize unfavorable development when we increase our previous estimate of ultimate losses, which results in a decrease in net income in the period recognized. Accordingly, while we record our best estimate, our claims reserves are subject to potential variability.

**(j) *Vehicle Floor Plan Payable***

Our consumer lending offerings consist of floor plan notes, which are loans to finance the purchase of auto vehicle inventory, also known as wholesale or inventory financing, as well as dealer loans, which are loans to finance improvements to dealership facilities, to provide working capital, and to purchase and/or finance dealership real estate – see note 5.

**(k) *Debt***

Our debt consists of borrowings under a credit agreement with a commercial bank and subordinated debentures. The credit loan borrowings and subordinated debentures are carried at principal amount borrowed – see notes 10 and 11.

**(l) *Mortgage Loan***

The mortgage loan was converted from a construction loan under a loan agreement with a commercial bank. The lending was to finance the purchase of the land, building costs and certain building related costs paid outside of the construction contract. Upon completion of the building the loan was converted into a mortgage with principal and interest due quarterly. The loan balance is carried at the outstanding principal balance at December 31, 2017 – see note 12.

**(m) *Treasury Stock***

The Company records treasury stock in accordance with the “cost method” described in ASC 505-30, *Equity – Treasury Stock* (“ASC 505-30”) – see note 13 for further discussion.

## **GAINSCO, INC. AND SUBSIDIARIES**

### Notes to Consolidated Financial Statements

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**(n) *Premium Revenues and Premium Receivables***

Premiums and policy fees are recognized as earned on a pro rata basis over the period the Company is at risk under the related policy. Agency revenues are primarily fees charged on insureds' premiums due. These fees are earned over the terms of the underlying policies. Unearned premiums represent the portion of premiums written and policy fees which are applicable to the unexpired terms of policies in force. Premiums receivable consist of balances owed for coverages written with the Company. The Company's allowance for doubtful accounts consists of all premiums receivables over thirty days past due.

**(o) *Gross Auto Sales, Cost of Auto Sales, and Finance Receivables***

Gross auto sales consist of sales of new and used vehicles, sales of parts and automotive services by our subsidiary BSHI. Cost of auto sales consist of vehicle procurement expenses, reconditioning expenses, auction fees and transportation to the dealership. We recognize revenue and expense associated with car sales in the period in which products are sold and delivered or services are provided. The automotive services we provide include, but are not limited to, customer-paid repairs and maintenance, as well as repairs and maintenance under manufacturer warranties and extended service contracts. Our finance receivables consists of smaller-balance, homogeneous loans carried at amortized cost, net of allowance for loan losses. We use a combination of forecasting methodologies to determine the allowance for loan losses. Contracts-in-transit primarily represent receivables from financial institutions for the portion of the vehicle sales price financed by our customers.

**(p) *Fair Value of Financial Instruments***

The Company's financial instruments consist primarily of cash, receivables, payables and debt instruments. The carrying values of these financial instruments approximate their respective fair values as they are either short-term in nature or carry interest rates which vary with the market. Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**(q) *Earnings Per Share***

Earnings per share ("EPS") for the years ended December 31, 2017 and 2016 is based on a weighted average of the number of common shares outstanding during each year – see note 14. Basic and diluted EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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(r) ***Accounting Pronouncements***

*Recently Adopted Policies*

In February 2018, the FASB issued Accounting Standards Update (“ASU”) No. 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, Topic 220* (ASU 2018-02), which amends ASC Topic 220 and ASC Topic 740 by addressing the stranded amounts of Accumulated other comprehensive income (“AOCI”) which may result from the enactment of the 2017 Tax Act. Though AOCI is presented on a net-of-tax basis, ASC Topic 740 requires that the effects of new tax laws on items in AOCI be recognized without a corresponding adjustment to AOCI and instead recorded to income tax expense. ASU 2018-02 permits stranded amounts of AOCI specifically resulting from the 2017 Tax Act to be removed from AOCI and reclassified to retained earnings, if elected. ASU 2018-02 is effective for fiscal years beginning after December 15, 2018, including interim periods therein, and early adoption is permitted. We adopted the guidance as of December 31, 2017 and recognized a \$195,000 reclassification from retained earnings to AOCI in the consolidated financial statements for the year ended December 31, 2017, related to a revaluation of deferred income tax assets and liabilities for items in AOCI at the 2017 Tax Act federal tax rate which changed from 34% to 21%.

*Pending Policies*

We have evaluated recent accounting pronouncements that have had or may have a significant effect on our financial statements or on our disclosures.

In March 2017 the FASB issued ASU No. 2017-08, *Receivables-Nonrefundable Fees and Other Costs (Subtopic 210-20), Premium Amortization on Purchased Callable Debt Securities* (ASU 2017-08). The guidance amends the amortization period for certain purchased callable debt securities held at a premium. Securities that contain explicit, noncontingent call features that are callable at fixed prices and on preset dates should shorten the amortization period for the premium to the earliest call date (and if the call option is not exercised, the effective yield is reset using the payment terms of the debt security). The standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and is to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings. We do not expect the adoption of this standard to have a material impact on our financial condition or results of operations.

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In January 2017, the FASB issued ASU No. 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* (ASU 2017-04). This update simplifies the manner in which an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. ASU 2017-07 is effective for annual periods beginning after December 15, 2019, including interim periods within those annual periods, with early adoption permitted for certain requirements. We do not intend to early adopt and are assessing the impact of adopting this new accounting standard on our consolidated financial statements and related disclosures.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows: Restricted Cash* (“ASC 230”). Under current guidance, restricted amounts of cash or cash equivalents are excluded from the cash flow statement. The new guidance requires restricted cash and restricted cash equivalents to be included in the reconciliation of beginning and end-of-period amounts presented on the statement of cash flows. In addition, the new guidance requires a description of the nature of the changes in restricted cash and cash equivalents during the periods presented. The updated guidance in ASU 2016-15 and ASU 2016-18 are both effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. We are still evaluating the impact this ASU will have on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments* (“ASC 230”), which addresses the classification and presentation of certain items, including debt prepayment and extinguishment costs, contingent consideration payments made after a business combination and distributions received from equity method investees, for which there was diversity in practice.

In June 2016, the FASB issued ASU 2016-13, *Measurement of Credit Losses on Financial Instruments* (“ASC 326”), which establishes new guidance for the recognition of credit losses for financial assets measured at amortized cost. The new ASU, which applies to financial assets that have the contractual right to receive cash requires reporting entities to estimate the credit losses expected over the life of a credit exposure using historical information, current information and reasonable and supportable forecasts that affect the collectability of the financial asset. The types of assets included in the scope of the new guidance includes premium receivables, reinsurance recoverables and loans. ASU 2016-13 is effective for annual periods beginning after January 1, 2020, including interim periods. The Company measures financial assets at fair value with changes therein recognized in current period earnings and accordingly, does not expect adoption to have a significant impact on its financial statements.

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In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)* (ASU 2016-02). This update is intended to replace existing lease guidance by requiring a lessee to recognize substantially all leases (whether operating or finance leases) on the balance sheet as a right-of-use asset and an associated lease liability. Short-term leases of 12 months or less are excluded from this amendment. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. We do not intend to early adopt and are assessing the impact of adopting this new accounting standard on our consolidated financial statements and related disclosures.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities* (ASU 2016-01). This update substantially revises standards for the recognition, measurement and presentation of financial instruments. This standard revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirements associated with the fair value of financial instruments. ASU 2016-01 is effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods, with early adoption permitted for certain requirements. We are assessing the impact of adopting this new accounting standard on our consolidated financial statements and related disclosures. We currently record equity securities at fair value and as of December 31, 2017, we have \$1.9 million net unrealized gains, net of taxes, recognized as a component of other comprehensive income.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). Insurance contracts have been excluded from the scope of this guidance. In August 2015, the FASB issued an ASU to defer the effective date for fiscal years beginning after December 15, 2016, to fiscal years beginning after December 15, 2017. Under the standard, guidance is provided on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The transaction price is attributed to underlying performance obligations in the contract and revenue is recognized as the entity satisfies the performance obligation and transfers control of the good or service to the customer. We do not intend to early adopt and note that the standard is not applicable to our insurance contracts or other revenue streams. The adoption of this new accounting standard does not have a material impact on our consolidated financial statements and related disclosures.



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In May 2015, the FASB issued ASC Update No. 2015-09, (Topic 944) *Financial Services- Insurance: Disclosures about Short-Duration Contracts*. This ASC update requires several additional disclosures regarding short-duration insurance contracts, including; disaggregated incurred and paid claims development information, quantitative and qualitative information about claim frequency and duration, and the sum of IBNR liabilities plus expected development on reported claims included in the liability for unpaid claims and claim adjustment expenses along with a description of reserving methodologies. This information is required to be presented by accident year, for the number of years for which claims typically remain outstanding, but need not exceed 10 years. A reconciliation of the claims development disclosures to the aggregate carrying amount of the liability for unpaid claims and claim adjustment expenses, including a separate disclosure for reinsurance recoverables is also required for each period presented in the statement of financial position. In addition, this ASC requires insurance entities to disclose information about significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses, including reasons for the change and the effects on the financial statements. The updated guidance is effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017 – see note 1(i).

All other codified accounting standards and interpretations of those standards issued during 2017 did not relate to accounting policies and procedures pertinent to the Company at this time.

(s) ***Reclassifications***

Certain amounts in the prior year's consolidated financial statements have been reclassified to conform to the current period presentation. These reclassifications had no material effect on total assets, total liabilities, total shareholders' equity, net income or net cash provided by operating activities as previously reported.

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#### (2) Investments

The following table summarizes the components of net investment income:

	Years ended December 31,	
	2017	2016
	(Amounts in thousands)	
Fixed maturities	\$ 5,460	5,834
Preferred stocks	456	130
Common stocks	621	499
Other long-term investments	203	214
Short-term investments	<u>387</u>	<u>257</u>
	7,127	6,934
Investment expenses	<u>(296)</u>	<u>(294)</u>
Net investment income	\$ <u>6,831</u>	<u>6,640</u>

The following tables summarize the amortized cost and estimated fair values of investments:

	December 31, 2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Other-than- temporary impairments in AOCI (1)
	(Amounts in thousands)				
Bonds, available for sale:					
U.S. Treasury	\$ 6,467	-	(92)	6,375	-
U.S. Government agencies	3,000	-	(25)	2,975	-
Corporate bonds	167,579	831	(1,559)	166,851	-
Asset-backed	1,557	-	(2)	1,555	-
Mortgage-backed	2,632	1	(25)	2,608	-
Preferred stocks, available for sale	8,372	388	(78)	8,682	-
Common stocks, available for sale	9,568	2,210	(128)	11,650	-
Certificates of deposit	100	-	-	100	-
Other long-term investments	12,368	-	-	12,368	-
Short-term investments	<u>46,395</u>	<u>-</u>	<u>(20)</u>	<u>46,375</u>	<u>-</u>
Total investments	\$ <u>258,038</u>	<u>3,430</u>	<u>(1,929)</u>	<u>259,539</u>	<u>-</u>

(1) Represents the amount of other-than-temporary impairment losses in "Accumulated other comprehensive income" or "AOCI" which, from January 1, 2009, were not included in earnings under ASC 320-10-65.

## GAINSCO, INC. AND SUBSIDIARIES

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December 31, 2016					
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Other-than- temporary impairments in AOCI (1)
(Amounts in thousands)					
Bonds, available for sale:					
U.S. Treasury	\$ 9,619	150	(47)	9,722	-
U.S. Government agencies	3,000	-	(12)	2,988	-
Corporate bonds	141,730	703	(3,014)	139,419	-
Mortgage-backed	4,404	-	(204)	4,200	(62)
Preferred stocks, available for sale	4,798	358	(49)	5,107	-
Common stocks, available for sale	5,988	14	(973)	5,029	-
Certificates of deposit	100	-	-	100	-
Other long-term investments	12,943	-	-	12,943	-
Short-term investments	<u>40,937</u>	<u>4</u>	<u>(19)</u>	<u>40,922</u>	<u>-</u>
Total investments	\$ <u>223,519</u>	<u>1,229</u>	<u>(4,318)</u>	<u>220,430</u>	<u>(62)</u>

(1) Represents the amount of other-than-temporary impairment losses in “Accumulated other comprehensive income” or “AOCI” which, from January 1, 2009, were not included in earnings under ASC 320-10-65.

The following tables summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of December 31, 2017 and 2016:

December 31, 2017						
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Amounts in thousands)						
U.S. Treasury	\$ 4,923	44	1,452	48	6,375	92
U.S. Government agencies	-	-	2,975	25	2,975	25
Corporate bonds	76,620	603	43,185	956	119,805	1,559
Asset-backed	1,555	2	-	-	1,555	2
Mortgage-backed	-	-	2,548	25	2,548	25
Preferred stocks	1,824	70	230	8	2,054	78
Common stocks	702	128	-	-	702	128
Short-term investments	<u>17,510</u>	<u>20</u>	<u>-</u>	<u>-</u>	<u>17,510</u>	<u>20</u>
Total investments	\$ <u>103,134</u>	<u>867</u>	<u>50,390</u>	<u>1,062</u>	<u>153,524</u>	<u>1,929</u>

## GAINSCO, INC. AND SUBSIDIARIES

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	December 31, 2016					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Amounts in thousands)					
U.S. Treasury	\$ 1,452	47	-	-	1,452	47
U.S. Government agencies	2,988	12	-	-	2,988	12
Corporate bonds	40,990	898	38,481	2,116	79,471	3,014
Mortgage-backed	-	-	4,120	204	4,120	204
Preferred stocks	-	-	656	49	656	49
Common stocks	-	-	4,927	973	4,927	973
Short-term investments	<u>17,346</u>	<u>19</u>	<u>-</u>	<u>-</u>	<u>17,346</u>	<u>19</u>
Total investments	<u>\$ 62,776</u>	<u>976</u>	<u>48,184</u>	<u>3,342</u>	<u>110,960</u>	<u>4,318</u>

The gross unrealized losses, shown in the above tables, totaling \$1,062,000 and \$3,342,000 as of December 31, 2017 and 2016, respectively, relate to 53 and 52 individual securities, respectively, which had been in an unrealized loss position for 12 months or more as of such dates. As of December 31, 2017, approximately 91% of the unrealized gross losses were with issuers rated as investment grade by Standard and Poor's ("S&P"). The decline in market value is primarily related to an increase in market interest rates since purchasing related to policy actions by the Federal Reserve. Another contributing factor has been the persistent low levels of short term interest rates, such as the 3-month London Interbank Offered Rate for U.S. dollar deposits ("LIBOR"), and the related fall in the forward expectations for these short term yields since the time of acquisition of floating rate and "fixed to floating" coupon rate securities. At this time based upon information currently available, the Company has the ability and the intent to hold the securities until it fully recovers the principal, which could require the Company to hold these securities until their maturity; therefore, the Company considers the impairment to be temporary.

In order to determine whether it is appropriate in an accounting period to recognize OTTI with respect to a portfolio security which has experienced a recovery in fair value and as to which the Company has the ability and intent to fully recover principal, the Company considers all available evidence and applies judgment. With corporate debt issues, firm specific performance, industry trends, legislative and regulatory changes, government initiatives, and the macroeconomic environment all play a role in the evaluation process. With respect to asset-backed securities (including mortgage-backed securities), the Company uses individual cash flow modeling in addition to other available information. In the case of securities as to which the Company has the ability and intent to fully recover amortized cost, based upon the present value of the principal

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and interest expected to be received using the current best estimates of material inputs, such as default frequencies, severities, and prepayment speeds, generally no OTTI would be recognized unless other factors suggest that it would be appropriate to do so. The principal factors that the Company considers in this analysis are the extent to which the fair value of the security has declined, the ratings given to the security by recognized rating agencies, trends in those ratings, and information available to the Company from securities analysts and other commentators, public reports and other credible information.

During 2017, the Company sold all positions in nonprime collateralized mortgage obligations (“Alt-A securities”). At December 31, 2016, the Company had \$1,804,000 in par value of the Alt-A securities with a carrying value and fair value of \$1,552,000 and \$1,357,000, respectively.

<u>Nonprime collateralized mortgage obligations</u>	<u>As of December 31,</u>	
	<u>2017</u>	<u>2016</u>
S&P Ratings:		
NR	<u>0%</u>	<u>100%</u>

Included in the Company’s fixed income portfolio are hybrid securities with a carrying value of \$20,012,000 and fair value of \$20,048,000 at December 31, 2017. A hybrid security as used here is one where the issuer of the debt instrument can choose to defer payment of the regularly scheduled interest due for a contractually set maximum period of time, usually five to ten years, without being in technical default on the issue.

Preferred stocks consist of an auction preferred instrument considered to be available for sale and reported at estimated fair value with the net unrealized gains or losses reported after-tax as a component of other comprehensive income, along with exchanged traded issues of public companies. The auction rate securities which the Company owns are each issued by a trust which holds as an asset the preferred stock of a corporation, which are exchange traded. The Company has the option at stated intervals to redeem the auction preferred shares for a pro rata share of the underlying collateral. As of December 31, 2017, management has not chosen this option as the structure of the trust provides a higher coupon on the auction preferred shares than on the underlying collateral shares; and therefore, are of greater economic value. As of December 31, 2017, management does not believe that any common shares are other-than-temporarily impaired based on the credit review of the issuer.

Common stocks predominately consist of shares of an exchange traded limited liability company, which invests in transportation and infrastructure related assets. This position resulted from the exchange of the Company’s ownership in a private limited partnership, previously categorized as Other long-term investments, for these common shares in conjunction with the partnership going public through an initial public offering in 2016. As of December 31, 2017, management does not believe that any underlying shares are other-than-temporarily impaired based on the credit review of the issuer.

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Investments in private partnerships or limited liability companies are accounted for under the cost method, which approximates cost. These companies are audited on an annual basis. The Company has classified these investments as Other long-term investments.

Estimated fair value of investments on deposit with various regulatory bodies, as required by law, were \$2,515,000 and \$5,140,000, at December 31, 2017 and 2016, respectively.

When a security has an unrealized loss in fair value that is deemed to be other than temporary, the Company reduces the carrying value of the security to its current market value, recognizing the decline as a realized loss in the statement of operations. These determinations can reflect the market-related issues associated with a disruption in the credit markets, which can create a significant deterioration in both the valuation of the securities, as well as the Company's view of future recoverability of the valuation decline. Also, if determined that a security is not likely to be held until the full recovery of amortized cost, the carrying value is reduced to the fair value.

As discussed in note 1, a portion of certain OTTI losses on debt securities are recognized in "Other comprehensive income" ("OCI"). The net amount recognized in earnings ("credit loss impairments") represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between fair value and amortized cost is recognized in OCI.

Proceeds from the sale of securities for the years ended December 31, 2017 and 2016 are presented in the following table:

	<u>Years ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	<u>(Amounts in thousands)</u>	
Proceeds:		
Bonds, available for sale	\$ <u>19,609</u>	<u>30,838</u>
Bonds, available for sale principal pay downs	\$ <u>218</u>	<u>1,353</u>
Preferred stocks, available for sale	\$ <u>1,697</u>	<u>-</u>
Common stock, available for sale	\$ <u>73</u>	<u>8,111</u>
Other invested assets	\$ <u>1,346</u>	<u>295</u>

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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Realized gains and losses on investments for the years ended December 31, 2017 and 2016 are presented in the following table:

	Years ended December 31,	
	2017	2016
	(Amounts in thousands)	
Realized gains:		
Bonds, available for sale	\$ 143	3,628
Preferred stocks, available for sale	-	-
Common stocks, available for sale	100	7,572
Other long term investments, cost	771	7,572
Short-term investments	<u>1</u>	<u>5</u>
Total realized gains	<u>1,015</u>	<u>11,205</u>
Realized losses:		
Bonds, available for sale	(426)	(553)
Preferred stocks, available for sale	(19)	-
Common stocks, available for sale	(27)	-
Short-term investments	<u>(12)</u>	<u>-</u>
Total realized losses	<u>(484)</u>	<u>(553)</u>
Other-than-temporary impairment losses	<u>-</u>	<u>(117)</u>
Total realized investment gains, net	\$ <u>531</u>	<u>10,535</u>

The amortized cost and estimated fair value of debt securities (including bonds available for sale, preferred stocks and certificates of deposit) at December 31, 2017 and 2016, by maturity, are shown below.

	2017		2016	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(Amounts in thousands)			
Due in one year or less	\$ 20,564	20,559	22,594	22,752
Due after one year but within five years	137,086	136,560	96,775	96,321
Due after five years but within ten years	3,720	3,758	15,118	15,153
Due after ten years but within twenty years	5,184	5,262	2,424	2,509
Due beyond 20 years	18,964	18,844	22,336	20,601
Asset-backed securities	1,557	1,555	-	-
Mortgage-backed securities	<u>2,632</u>	<u>2,608</u>	<u>4,404</u>	<u>4,200</u>
	\$ <u>189,707</u>	<u>189,146</u>	<u>163,651</u>	<u>161,536</u>

## GAINSCO, INC. AND SUBSIDIARIES

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The following table summarizes the S&P ratings on the Company's bonds available for sale as of December 31, 2017:

<u>Bonds available for sale</u>	<u>2017</u>
S&P Ratings:	
AAA	1%
AA+	8
AA-	3
A+	4
A	10
A-	8
BBB+	25
BBB	29
BBB-	5
BB and below	<u>7</u>
	<u>100%</u>

The following table sets forth the amount of credit loss impairments on debt securities held by the Company as of December 31, 2017, for which a portion of the OTTI loss was recognized in OCI, and the corresponding changes in such amounts.

	<u>(Amounts in thousands)</u>
Balance, January 1, 2017	\$ 7,316
Credit losses remaining in accumulated deficit related to adoption of ASC 320-10-65	-
Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period	-
Credit loss impairments previously recognized on securities impaired to fair value during the period	-
Credit loss impairments recognized in the current period on securities not previously impaired (1)	-
Additional credit loss impairments recognized in the current period on securities previously impaired	-
Increases due to the passage of time on previously recorded credit losses	-
Balance, December 31, 2017	\$ <u>7,316</u>

(1) Represents circumstances where the Company determined in the current period that it intends to sell the security or it is more likely than not that it will be required to sell the security before recovery of the security's amortized cost.

During 2017, the Company had no write downs in securities that were determined to have had an other-than-temporary decline in fair value. During 2016, the Company wrote down \$117,000 in securities that were determined to have had an other-than-temporary decline in fair value.



## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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#### (3) Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in ASC 320-10-65. The framework is based on the inputs used in valuation, gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates in the ASC 320-10-65 hierarchy is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices in markets that are not active or inputs that are observable directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities other than quoted prices in Level 1; quoted prices in markets that are not active; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or other inputs that are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 – Unobservable inputs that are supported by little or no market activity and are significant to their fair value of the assets or liabilities. Unobservable inputs reflect the Company's own estimates as to the assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose values are determined using pricing models and third-party evaluation, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

#### Valuation of Investments

The Company receives pricing from independent pricing services, and these are compared to prices available from sources accessed through the Bloomberg Professional System. The number of available quotes varies depending on the security, generally management obtains one quote for Level 1 investments, one to three quotes for Level 2 investments and one to two quotes, if available, for Level 3 investments. If there is a material difference in the prices obtained, further evaluation is made. Market prices and valuations from sources such as the Bloomberg system, TRACE and dealer offerings are used as a check on the prices obtained from the independent pricing services. Should a material difference exist, then an internal valuation is made. For purposes of valuing these securities management produces expected cash flows for the security utilizing the standard security modeling capabilities available on the Bloomberg Professional System. The key inputs for mortgage securities are the default rate, severity of default, and voluntary prepayment rate for the underlying mortgage collateral. These are generally based at

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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the start on the actual historical values of these parameters for the prior six months. These cash flows are then discounted by a required yield derived from market based observations of broker inventory offerings, or in some cases Bloomberg Indices of like securities. Management uses this valuation model primarily with mortgage-backed securities where the matrix pricing methodology used by the independent pricing service is too broad in its categorizations. This often involves differences in reasonable prepayment assumptions or significant differences in performance among issuers. In some cases, other external observable inputs such as credit default swap levels are used as input in the fair value analysis.

**Fixed Maturities, Equity Securities and Mortgage-backed Instruments** – For U. S. Treasury, U. S. government and corporate bonds, the independent pricing services obtain information on actual transactions from a large network of broker-dealers and determine a representative market price based on trading volume levels. For mortgage-backed instruments, the independent pricing services obtain information on actual transactions from a large network of broker-dealers and sorts the information into various components, such as asset type, rating, maturity, and spread to a benchmark such as the U.S. Treasury yield curve. These components are used to create a pricing matrix for similar instruments. All broker-dealer quotations obtained are non-binding.

The Company uses the following hierarchy for each instrument in total invested assets:

1. The Company obtains a price from an independent pricing service.
2. If no price is available from an independent pricing service for the instrument, the Company obtains a market price from a broker-dealer or other reliable source, such as Bloomberg.
3. The Company then validates the price obtained by evaluating its reasonableness. The Company's review process includes quantitative analysis (i.e., credit spreads and interest rate and prepayment fluctuations) and initial and ongoing evaluations of methodologies used by outside parties to calculate fair value and comparing the fair value estimates to its knowledge of the current market. If a price provided by a pricing service is considered to be materially different from the other indications that are obtained, the Company will make a determination of the proper fair value of the instrument based on data inputs available.

In order to determine the proper ASC 320-10-65 classification for each instrument, the Company obtains from its independent pricing service the pricing procedures and inputs used to price the instrument. The Company analyzes this information, taking into account asset type, rating and liquidity, to determine what inputs are observable and unobservable in order to determine the proper ASC 320-10-65 level. For those valued internally, a determination is made as to whether all relevant inputs are observable or unobservable in order to classify correctly.

## GAINSCO, INC. AND SUBSIDIARIES

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All of the Company's Level 1 and Level 2 invested assets held were priced using either independent pricing services or available market prices to determine fair value. The Company classifies such instruments in active markets as Level 1 and those not in active markets as Level 2. The Preferred stocks in Level 3 were auction preferred instruments and were classified in Level 3 because the market in which they trade remains very inactive. The Corporate bonds in Level 3 are private placements which rarely trade and the issuers have no other debt outstanding to provide a valuation benchmark. The residential mortgage-backed securities which are valued in the manner described above are classified as Level 3. Those for which the individual pricing service value is used are classified as Level 2.

**Corporate Bonds** – the fair value is estimated using discounted cash flow analyses by applying the maximum credit utilization schedule set by statute, so the only unobservable input variable is the appropriate market discount rate. The discount rate takes into account general market trends, including inputs from spreads based on U.S. Treasury yield curves in the pricing of the instrument when it was originally issued and considering current yields of like maturities. Due to the short duration of the issue, its sensitivity to the discount rate assumption is minimal.

**Preferred Stocks** – the security is redeemable upon demand within ten business days into a specific number of shares of the underlying collateral of the issuing trust. The underlying shares form the basis of the fair value determination and thus the Company estimates the fair value using a liquidation value of collateral approach. The collateral is comprised of preferred shares publically traded on the New York Stock Exchange and is used as a direct market observable input. Unobservable inputs consist of short lag time and procedural issues involved in obtaining collateral shares, the liquidity of the underlying shares due to the security being an auction rate security resulting in a slightly higher trading yield. The Company's assumption for the estimate for the auction rate preferred shares is set directly equal to that of the underlying collateral shares for which it could be redeemed.

**GAINSCO, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

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The quantitative disclosures about the fair value measurements for each major category of assets at December 31, 2017 and 2016 were as follows:

	December 31, <u>2017</u>	Quoted Prices in Active Markets <u>(Level 1)</u>	Significant Other Observable Inputs <u>(Level 2)</u>	Significant Unobservable Inputs <u>(Level 3)</u>
(Amounts in thousands)				
Assets:				
U.S. Treasury	\$ 6,375	6,375	-	-
U.S. Government agencies	2,975	-	2,975	-
Corporate bonds	166,851	-	166,851	-
Asset-backed	1,555	-	1,555	-
Mortgage-backed	<u>2,608</u>	<u>-</u>	<u>2,608</u>	<u>-</u>
Total available-for-sale securities	180,364	6,375	173,989	-
Preferred stocks	8,683	4,748	-	3,935
Common stocks	11,650	11,650	-	-
Certificates of deposit	100	100	-	-
Short-term investments	<u>46,375</u>	<u>30,860</u>	<u>15,515</u>	<u>-</u>
Total assets classified by ASC 320-10-65(1)	\$ <u>247,172</u>	<u>53,733</u>	<u>189,504</u>	<u>3,935</u>
Percentage of total	<u>100%</u>	<u>22%</u>	<u>77%</u>	<u>1%</u>

(1) The investments classified as Other long-term investments are outside the scope of ASC 320-10-65 and, therefore, not disclosed in the table as invested assets classified by ASC 320-10-65.

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Notes to Consolidated Financial Statements

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	December 31, <u>2016</u>	Quoted Prices in Active Markets <u>(Level 1)</u>	Significant Other Observable Inputs <u>(Level 2)</u>	Significant Unobservable Inputs <u>(Level 3)</u>
(Amounts in thousands)				
Assets:				
U.S. Treasury	\$ 9,722	9,722	-	-
U.S. Government agencies	2,988	-	2,988	-
Corporate bonds	139,419	-	139,419	-
Mortgage-backed	<u>4,200</u>	<u>-</u>	<u>4,200</u>	<u>-</u>
Total available-for-sale securities	156,329	9,722	146,607	-
Preferred stocks	5,107	1,156	-	3,951
Common stocks	5,029	5,029	-	-
Certificates of deposit	100	100	-	-
Short-term investments	<u>40,922</u>	<u>19,325</u>	<u>21,597</u>	<u>-</u>
Total assets classified by ASC 320-10-65(1)	\$ <u>207,487</u>	<u>35,332</u>	<u>168,204</u>	<u>3,951</u>
Percentage of total	<u>100%</u>	<u>17%</u>	<u>81%</u>	<u>2%</u>

(1) The investments classified as Other long-term investments are outside the scope of ASC 320-10-65 and, therefore, not disclosed in the table as invested assets classified by ASC 320-10-65.

Level 1 includes U.S. Treasury securities and exchange-traded securities. Level 2 securities are comprised of securities whose fair value was determined using observable market inputs. Investments classified as Level 3 are primarily comprised of the following: (i) with respect to fixed maturity investments, certain corporation and mortgage-backed securities that values provided by an independent pricing service or quoted market prices were not used, many of which are not publicly traded or are not actively traded; and (ii) with respect to equity securities, preferred securities.

## GAINSCO, INC. AND SUBSIDIARIES

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The following table provides a summary of changes in fair value associated with the Level 3 assets for the years ended December 31, 2017 and 2016:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	December 31,	
	2017	2016
	(Amounts in thousands)	
Beginning balance	\$ 3,951	859
Total gains or losses (realized/unrealized):		
Included in earnings (or changes in net assets)	-	-
Included in other comprehensive loss	(16)	92
Purchases, issuances, and settlements, net	-	3,000
Transfers in and/or out of Level 3	-	-
Ending balance	\$ <u>3,935</u>	<u>3,951</u>

The above table of Level 3 assets begins with the prior period balance and adjusts the balance for the gains or losses (realized and unrealized) that occurred during the current period. Any new purchases that are identified as Level 3 securities are then added and any sales of securities which were previously identified as Level 3 are subtracted. Next, any securities which were previously identified as Level 1 or Level 2 securities and which are currently identified as Level 3 are added. Finally, securities which were previously identified as Level 3 and which are now designated as Level 1 or as Level 2 are subtracted. The ending balance of the Level 3 securities presented above represent our best estimates and may not be substantiated by comparisons to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

The Company wrote down Alt-A securities (Level 2) totaling \$117,000 for the year ended December 31, 2016 that were determined to have had an other-than-temporary credit related impairment charge. The Company had no write downs during 2017 in securities that were determined to have had an other-than-temporary credit related impairment charge.

There were no transfers between Levels 1 and 2 during the periods presented.

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**(4) Property and Equipment**

The following schedule summarizes the components of property and equipment:

	As of and for the years ended December 31	
	2017	2016
	(Amounts in thousands)	
Leasehold improvements	\$ 1,777	1,524
Land	1,755	1,755
Building	5,243	5,243
Furniture, fixtures and automobiles	6,752	6,405
Equipment	4,137	3,993
Software	8,440	7,131
Accumulated depreciation and amortization	(15,430)	(14,104)
Property and equipment, net	\$ <u>12,674</u>	<u>11,947</u>
Depreciation expense	\$ <u>2,687</u>	<u>3,052</u>

**(5) Inventory and Vehicle Floor Plan Payable**

The components of inventory at December 31 are as follows:

	2017	2016
	(Amounts in thousands)	
New/demo vehicles	\$ 7,376	5,251
Used vehicles	2,149	2,546
Parts, accessories, and other	<u>434</u>	<u>343</u>
Auto vehicle inventory	\$ <u>9,959</u>	<u>8,140</u>

The components of vehicle floor plan payables at December 31 are as follows:

	2017	2016
	(Amounts in thousands)	
Vehicle floor plan payable – new/demo	\$ 8,366	6,097
Vehicle floor plan payable – used	<u>1,694</u>	<u>1,672</u>
Vehicle floor plan note payable	\$ <u>10,060</u>	<u>7,769</u>

Vehicle floor plan payable reflects amounts borrowed to finance the purchase of vehicle inventories. In general, the floor plan line is secured by all financed vehicles. Changes in vehicle floor plan payable are reported as non-cash supplemental financing activities in the accompanying Consolidated Statements of Cash Flows.

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Our inventory consists of new, used and demonstrator automobiles sold to consumers. Vehicles are carried at lower of cost-or-market. Cost is computed as amortized cost less manufacturer incentives. The vehicle floor plan payable, as shown in the above table, will generally be lower than the inventory cost due to the timing of the sale of a vehicle and payment of the related liability.

Vehicle floor plan facilities are due on demand, but in the case of new vehicle inventories, are generally paid within several business days after the related vehicles are sold. Our manufacturer agreements generally require that the manufacturer have the ability to draft against the new vehicle floor plan facilities so the lender directly funds the manufacturer for the purchase of new vehicle inventory. Vehicle floor plan facilities are primarily collateralized by vehicle inventories and related receivables.

The floor plan note is usually structured to yield interest at a floating rate indexed to the prime rate. The rate for a particular dealership is based on, among other things, the dealership's credit worthiness, the amount of the credit line, the risk rating and whether or not the dealership is in default. Interest on floor plan loans is payable monthly on the first day of each month, accrued on any outstanding principal balance at a floating rate of prime less 0.5%.

At December 31, 2017, the monthly interest rate equaled 4.50%. The amount of the floor plan note as of December 31, 2017 totaled \$10,060,000 covering new and used auto vehicle inventory. The Company is able to make advances from time to time and all advances are evidenced by a promissory note. The credit agreement governing the promissory note contains covenants regarding limits on borrowing/curtailment to new, used, aged used and demo auto vehicles. The agreement also contains financial covenants regarding tangible net worth and maximum loan to value position. For the year ended December 31, 2017, BSHI expensed and paid interest on the floor plan note total \$324,000 and \$342,000, respectively. For the year ended December 31, 2016, BSHI expensed and paid interest on the floor plan note total \$166,000 and \$160,000, respectively.



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#### (6) Federal Income Taxes

In the accompanying consolidated statements of operations, the provisions for Federal income tax as a percent of related pretax income differ from the Federal statutory income tax rate. A reconciliation of income tax expense using the Federal statutory rates to actual income tax expense follows:

	December 31,	
	2017	2016
	(Amounts in thousands)	
Income tax expense at 34%	\$ 7,123	6,278
Change in enacted tax rates	2,037	-
Other, net	<u>98</u>	<u>197</u>
Income tax expense	\$ <u>9,258</u>	<u>6,475</u>

The Company recognized a current tax expense for Federal income tax for the years ended December 31, 2017 and 2016:

	2017	2016
	(Amounts in thousands)	
Current federal tax expense	\$ <u>3,406</u>	<u>402</u>
Current state tax expense	\$ <u>588</u>	<u>314</u>
Federal income tax paid	\$ <u>2,527</u>	<u>492</u>

Under ASC 740, the primary objective is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. The portion of the tax expense, which is a result of the change in the deferred tax asset or liability, may not always be consistent with the income reported on the statements of operations. At December 31, 2017, the Company has not identified any material uncertain tax positions in accordance with ASC 740.

During 2017, the Company fully utilized the NOL and Alternative Minimum Tax carryforwards. The Company does not record a tax valuation allowance relating to the net unrealized losses on investments, excluding common stocks, because it is more likely than not that these losses would reverse or be utilized in future periods. The Company has the ability and it is the Company's intent to fully recover the principal, which could require the Company to hold these securities until their maturity; therefore, the Company considers the impairment to be temporary.

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On December 22, 2017, the 2017 Tax Act was signed into law. One of the provisions of the 2017 Tax Act reduced the corporate federal income tax rate from 34% to 21% effective January 1, 2018. The SEC staff issued Staff Accounting Bulletin 118 (SAB 118), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 addresses situations where accounting for certain income tax effects of the Tax Act under ASC 740 may be incomplete upon issuance of an entity's financial statements and provides a one-year measurement period from the enactment date to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the following:

- Income tax effects of those aspects of the 2017 Tax Act for which accounting under ASC740 is complete;
- Provisional estimate of income tax effects of the 2017 Tax Act to the extent accounting is incomplete but a reasonable estimate is determinable; and
- If a provisional estimate cannot be determined, ASC 740 should still be applied on the basis of tax law provisions that were in effect immediately before the enactment of the 2017 Tax Act.

We revalued all deferred tax assets and liabilities to recognize the tax rate that is expected to apply when the tax effects are ultimately recognized in future periods. The impact of revaluing the deferred tax assets and liabilities from 34% to 21% was an increase to income tax expense of \$2,037,000, as disclosed in the aforementioned table. This revaluation adjustment included a \$195,000 reduction related to the deferred tax liability associated with the net unrealized gains on our investment portfolio, which was originally recorded as a component of other comprehensive income and not through the tax provision. The remainder was associated with our other deferred tax assets and liabilities identified in the table below.

Deferred income taxes, which are included in other assets or other liabilities as appropriate, reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. As noted above, the federal deferred tax assets and liabilities at December 31, 2017, have been revalued to reflect the new 21% federal corporate income tax rate under the 2017 Tax Act.

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The following table represents the tax effect of temporary differences giving rise to the net deferred tax asset established under ASC 740.

	As of December 31,	
	2017	2016
	(Amounts in thousands)	
Deferred tax assets:		
Net operating loss carryforward	\$ -	2,038
Discount on unearned premium reserve	3,126	4,196
Deferred compensation	865	923
Unearned fees	669	925
Business combination	524	1,020
Alternative Minimum Tax carryforward	-	1,534
Discount on unpaid claims and claim adjustment expenses	458	698
Allowance for doubtful accounts	223	333
Realized capital losses	177	443
Depreciation and amortization	67	118
Net unrealized losses on investments	-	1,050
Other	<u>7</u>	<u>7</u>
Total deferred tax assets	<u>6,116</u>	<u>13,285</u>
Deferred tax liabilities:		
Deferred policy acquisition costs	2,522	3,229
Accrual of discount on bonds	303	452
Net unrealized gains on investments	<u>315</u>	<u>-</u>
Total deferred tax liabilities	<u>3,140</u>	<u>3,681</u>
Net deferred tax asset	\$ <u>2,976</u>	<u>9,605</u>

During 2016, the Company reduced the valuation allowance associated with the deferred tax asset by \$2,850,000, which is the change in the expectation on the utilization of the NOL carryforwards and all temporary differences resulting in no valuation allowance. Under ASC 740, positive evidence, such as taxable income over the most recent three-year period and other available objective and subjective evidence, requires management to conclude that it is “more likely than not” that a portion or all of the deferred tax benefit will be realized. While both objective and subjective evidence are considered, objective evidence should generally be given more weight in the analysis under ASC 740. In making the determination, the Company considered all available evidence, including the fact that the Company had estimated cumulative taxable income for the three years ended December 31, 2016 of approximately \$43,129,000. During 2017, the Company fully utilized the remaining portion of the \$2,038,000 of the net operating loss carryforward prior to its expiration.

## GAINSCO, INC. AND SUBSIDIARIES

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#### (7) Goodwill and Intangible Assets

Goodwill (insurance operations) and intangible assets, at December 31 consist of the following:

	<u>2017</u>	<u>2016</u>
	(Amounts in thousands)	
Goodwill – insurance operations	\$ <u>609</u>	<u>609</u>
Intangible assets	\$ <u>2,993</u>	<u>2,993</u>

##### (a) *Goodwill*

We test goodwill of our reporting units for impairment annually on December 31 or more frequently when events or changes in circumstances indicate that the carrying value of a reporting unit more likely than not exceeds its fair value.

Under accounting standards, an entity is permitted to first make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it is necessary to calculate the fair value of a reporting unit under the quantitative two-step goodwill impairment test. We completed qualitative annual assessments of any potential goodwill impairment as of December 31, 2017 and 2016. Based on our qualitative assessments, we determined that it was not more likely than not that the fair values of our reporting units were less than their carrying amounts and we were therefore not required to perform the two-step goodwill impairment test for any of our reporting units.

The quantitative goodwill impairment test is a two-step approach. The first step of the quantitative goodwill impairment test requires a determination of whether the fair value of a reporting unit is less than its carrying value. If the fair value of the reporting unit is less than the carrying value, the second step is required, which involves an analysis reflecting the allocation of the fair value determined in the first step (as if it was the purchase price in a business combination). This process may result in the determination of a new amount of goodwill. If the calculated fair value of the goodwill resulting from this allocation is lower than the carrying value of the goodwill in the reporting unit, the difference is reflected as a non-cash impairment loss. The purpose of the second step is only to determine the amount of goodwill that should be recorded on the balance sheet. The recorded amounts of other items on the balance sheet are not adjusted.

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In a quantitative impairment test, we estimate the fair value of our reporting units using an “income” valuation approach, which discounts projected free cash flows of the reporting unit at a computed weighted average cost of capital as the discount rate. The income valuation approach requires the use of significant estimates and assumptions, which include revenue growth rates and future operating margins used to calculate projected future cash flows, weighted average costs of capital, and future economic and market conditions. We base our cash flow forecasts on our knowledge of the insurance industry, our recent performance, our expectations of our future performance, and other assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

**(b) *Intangible Assets***

Our principal identifiable intangible asset is the excess of the purchase price over the fair value of the net tangible assets acquired, which has an indefinite life and is tested at least annually on December 31 for impairment. As discussed in Note 1 above, the FASB issued an accounting standard update that permits an entity to first make a qualitative evaluation about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it is necessary to perform a quantitative impairment test.

We completed our qualitative assessment of any potential franchise license impairment as of December 31, 2017. Based on our qualitative assessment, we determined that it was more likely than not that the fair values of our other intangible assets were less than their carrying amounts and we therefore performed a quantitative impairment test.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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We performed a quantitative annual impairment test as of December 31, 2017, and management determined that no additional impairment charge was needed. We performed a quantitative annual impairment test as of December 31, 2016, and recorded a \$2,047,000 non-cash impairment charge related to the other intangible assets associated with the Auto Group operations with the result of BSHI. This non-cash impairment charge was recorded to reduce the carrying value of the intangible assets to its estimated fair value, resulting in an intangible asset of \$2,993,000 on our Consolidated Balance Sheet as of December 31, 2016. The decline in the fair value of intangible assets related to BSHI reflects the underperformance relative to expectations of the auto dealership since our acquisition of it, as well as our expectations for the auto dealership's future prospects. These factors resulted in a reduction in forecasted cash flows and growth rates used to estimate fair value. This non-cash impairment charge is classified as Underwriting and operating expenses in the Consolidated Statements of Income and shown as Impairment of intangible assets in the Consolidated Statements of Cash Flows.

The quantitative impairment test for intangibles with indefinite lives requires the comparison of estimated fair value to its carrying value. We estimate the fair value of our reporting units using an "income" valuation approach, which discounts projected free cash flows of the reporting unit at a computed weighted average cost of capital as the discount rate. The income valuation approach requires the use of significant estimates and assumptions, which include revenue growth rates and future operating margins used to calculate projected future cash flows, weighted average costs of capital, and future economic and market conditions. We base our cash flow forecasts on our knowledge of the insurance industry, our recent performance, our expectations of our future performance, and other assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

#### **(8) Claims and Claim Adjustment Expenses**

The following table sets forth information about incurred and paid claims and allocated claim adjustment expense development as of December 31, 2017, net of reinsurance, as well as cumulative claim frequency and the total IBNR liabilities plus expected development on reported claims and allocated claim adjustment expenses included within the net incurred claims and allocated claim adjustment expenses amounts, amounts in dollars except for reported claims.

**GAINSCO, INC. AND SUBSIDIARIES**

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The information about incurred and paid claims and allocated claim adjustment expense development for the years ended December 31, 2008 to 2016 is presented as supplementary information.

Incurred Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance											As of December 31, 2017	
For the Years Ended December 31,											Total of IBNR Liabilities Plus Expected Development on Reported Claims	Cumulative Number of Reported Claims
Accident Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017		
(Amounts in thousands)												
2008	\$ 113,295	\$ 109,779	\$ 109,150	\$ 110,389	\$ 113,822	\$ 116,532	\$ 117,005	\$ 117,042	\$ 116,959	\$ 117,080	\$ 102	41,411
2009		126,203	122,955	126,236	132,679	137,596	140,546	139,605	139,545	139,587	40	50,759
2010			102,746	99,155	105,130	109,386	112,741	112,514	112,086	112,380	199	41,336
2011				103,406	96,493	103,021	106,688	107,227	107,484	108,377	68	40,047
2012					111,572	104,755	109,837	109,577	109,945	111,186	553	40,877
2013						108,234	100,055	99,157	99,474	100,478	49	39,751
2014							108,801	106,117	104,762	105,810	258	42,475
2015								134,817	133,495	134,263	1,361	48,426
2016									145,384	142,779	4,822	50,762
2017										<u>146,302</u>	30,591	46,838
									Total	\$ 1,217,242		

Cumulative Paid Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance										
For the Years Ended December 31,										
Accident Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
(Amounts in thousands)										
2008	\$ 67,752	99,512	105,441	107,811	112,010	115,894	116,463	116,787	116,853	\$ 116,913
2009		77,537	110,508	119,537	128,944	136,143	138,634	139,336	139,436	139,488
2010			60,967	87,785	99,146	107,232	110,391	111,653	111,913	112,028
2011				54,293	82,754	98,266	103,287	105,930	106,798	107,160
2012					63,635	93,955	103,269	107,279	108,727	110,122
2013						59,468	86,738	94,075	97,608	99,743
2014							63,214	92,485	100,543	104,245
2015								79,863	118,885	129,666
2016									92,140	129,826
2017										<u>85,000</u>
									Total	\$ 1,134,191
									All outstanding liabilities before 2008, net of reinsurance	<u>41</u>
									Liabilities for claims and allocated claim adjustment expense, net of reinsurance	\$ <u>83,092</u>

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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The reconciliation of the net incurred and paid claims and allocated claim adjustment expense development tables to the liability for CAE in the consolidated statement of financial position is as follows as of and for the year ended December 31, 2017 (amounts in thousands):

	December 31, 2017
Net outstanding liabilities	
Liabilities for unpaid claims and allocated claim adjustment expenses, net of reinsurance	\$ 83,092
Reinsurance recoverable on unpaid claims	57
Unallocated claims adjustment expenses	<u>11,338</u>
Total gross liability for unpaid claims and claim adjustment expense	\$ <u>94,487</u>

The following is supplemental information about average historical claims duration as of December 31, 2017:

	Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance									
	1	2	3	4	5	6	7	8	9	10
Years										
Private Passenger	<u>57.7%</u>	<u>26.5%</u>	<u>8.4%</u>	<u>4.5%</u>	<u>2.9%</u>	<u>1.7%</u>	<u>0.4%</u>	<u>0.2%</u>	<u>0.0%</u>	<u>0.1%</u>

Significant risk factors exist in the estimation of unpaid claims and claim adjustment expense through exposure to changes in the nonstandard personal auto claims operation. The selected estimates make reasonable provision for extraordinary future emergence of new classes of claims or types of claims not sufficiently represented in the Company's historical base or which are not yet quantifiable, and other risk factors could be identified in the future as having been a significant influence on the Company's unpaid claims and claim adjustment expenses.

The Company completes a full actuarial analysis of unpaid claims and claim adjustment expenses on a quarterly basis for each of its coverage lines. Based upon this actuarial analysis and the new information that becomes available during the quarter, unpaid claims and claim adjustment expenses are re-estimated each quarter.



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Notes to Consolidated Financial Statements

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The following table sets forth the changes in unpaid claims and claim adjustment expenses, net of reinsurance cessions, as shown in the Company's consolidated financial statements for the periods indicated:

	As of and for the years ended	
	December 31,	
	<u>2017</u>	<u>2016</u>
	(Amounts in thousands)	
Unpaid claims and claim adjustment expenses, beginning of period	\$ 83,575	87,664
Less: Ceded unpaid claims and claim adjustment expenses, beginning of period	-	-
Net unpaid claims and claim adjustment expenses, beginning of period	<u>83,575</u>	<u>87,664</u>
Net claims and claim adjustment expense incurred related to:		
Current period	178,080	174,467
Prior periods	<u>1,101</u>	<u>(8,430)</u>
Total net claim and claim adjustment expenses incurred	<u>179,181</u>	<u>166,037</u>
Net claims and claim adjustment expenses paid related to:		
Current period	108,984	114,521
Prior periods	<u>59,342</u>	<u>55,605</u>
Total net claim and claim adjustment expenses paid	<u>168,326</u>	<u>170,126</u>
Net unpaid claims and claim adjustment expenses, end of period	94,430	83,575
Plus: Ceded unpaid claims and claim adjustment expenses, end of period	<u>57</u>	-
Unpaid claims and claim adjustment expenses, end of period	\$ <u>94,487</u>	<u>83,575</u>

The unfavorable (favorable) developments in net claims and claim adjustment expenses paid was primarily attributable to the difference in actual and expected claims frequency and severity associated with the various coverages underwritten. As of December 31, 2017, management believes the balance sheet carried reserves made a reasonable provision for all unpaid claims and claim adjustment expense obligations of the Company under the terms of its contracts and reinsurance agreements.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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The following table presents the (unfavorable) favorable development for claims occurring in prior accident years for each region for the years ended December 31, 2017 and 2016:

<u>Region:</u>	December 31,	
	2017	2016
	(Amounts in thousands)	
Southeast (Florida, Georgia, South Carolina, Tennessee and Virginia)	\$ (279)	\$ 7,738
Southwest (Arizona, California, New Mexico, Nevada Utah, and Texas)	(846)	660
Other	<u>24</u>	<u>32</u>
Net (unfavorable) favorable development	\$ <u>(1,101)</u>	\$ <u>8,430</u>

#### (9) Reinsurance

##### (a) Assumed

The Company has, in the past, utilized reinsurance arrangements with various non-affiliated admitted insurance companies, whereby the Company underwrote the coverage and assumed the policies 100% from the companies. These arrangements required that the Company maintain escrow accounts to assure payment of the unearned premiums and unpaid claims and CAE relating to risks insured through such arrangements and assumed by the Company. As of December 31, 2017 and 2016, the balance held in trust in conjunction with reinsurance agreements totaled \$139,000 and \$123,000, respectively.

The following table summarizes the amounts related to the arrangements as of and for the years ended December 31, 2017 and 2016:

	December 31,	
	2017	2016
	(Amounts in thousands)	
Balances held in escrow	\$ <u>139</u>	<u>123</u>
Premiums earned by assumption	\$ <u>181</u>	<u>227</u>
Assumed unpaid claims and claim adjustment expenses	\$ <u>150</u>	<u>112</u>

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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**(b) Ceded**

In 2017, the Company maintained catastrophe reinsurance on its physical damage coverage for property claims of \$6,500,000 in excess of \$1,000,000 for a single catastrophe, as well as \$19,500,000 for aggregate catastrophes.

For 2016, the Company maintained catastrophe reinsurance on its physical damage coverage for property claims of \$6,500,000 in excess of \$1,000,000 for a single catastrophe, as well as \$14,500,000 for aggregate catastrophes.

The amounts included in the consolidated statement of operations for reinsurance ceded as of and for the years ended December 31, 2017 and 2016, respectively, are set forth in the following table:

	<u>December 31,</u>	
	<u>2017</u>	<u>2016</u>
	(Amounts in thousands)	
Premiums earned – nonstandard personal auto	\$ <u>788</u>	<u>411</u>
Claims and claim adjustment expenses – catastrophe	\$ <u>57</u>	<u>-</u>

The Company remains directly liable to their policyholders for all policy obligations and the reinsuring companies are obligated to the Company to the extent of the reinsured portion of the risks.

**(10) Note Payable**

In September 2005, the Company entered into a credit agreement with a commercial bank. Interest, payable quarterly, accrued on any outstanding principal balance at a floating rate equal to the 3-month LIBOR. Subsequent amendments changed the interest rate to 2.25% over the 3-month LIBOR, with no minimum, and a usage fee of 0.25% on the unused line of credit, converted the credit agreement to a revolving loan with a revolving commitment of up to \$20,000,000 and a maturity of December 2018.

The Company is able to draw on this revolving loan and repay in increments of \$100,000 without premium or penalty. Borrowings under the revolving loan are collateralized by the common stock of MGA and NSL, and payment is guaranteed by NSL. The credit agreement governing the revolving loan contains covenants regarding limits on levels of subsidiary indebtedness, liens, investments, acquisitions, certain mergers, certain asset sales outside the ordinary course of business, and change in control as defined in the agreement. The agreement also contains financial covenants regarding capital of MGA, consolidated net worth of GANS and the combined ratio of the personal auto operation.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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#### (11) Subordinated Debentures

In January 2006, GANS issued \$25,000,000 of 30-year subordinated debentures. They require quarterly interest payments at a floating interest rate equal to the 3-month LIBOR plus a margin of 3.85%. They will mature on March 31, 2036 and are redeemable at GANS' option, in whole or in part, at the liquidation amount of \$1,000 per debenture.

In December 2006, GANS issued \$18,000,000 of 30-year subordinated debentures. They require quarterly interest payments at a floating interest rate equal to the 3-month LIBOR plus a margin of 3.75%. They will mature on March 15, 2037 and are redeemable at GANS' option, in whole or in part, at the liquidation amount of \$1,000 per debenture.

#### (12) Mortgage Loan Payable

In August 2015, a construction loan was converted into a mortgage loan with the same commercial bank per the loan agreement. The amount of the original loan note was \$5,680,000 with interest payable quarterly on any outstanding principal balance at a floating rate equal to 3-month LIBOR plus 2.25%. Principal payments are payable quarterly at \$71,000 per quarter. The outstanding mortgage loan amount was \$5,041,000 as of December 31, 2017.

The following table summarizes net interest expense recorded and interest payments made in 2017 and 2016:

	2017		2016	
	Net interest expense	Interest payments	Net interest expense	Interest payments
	(Amounts in thousands)			
Note payable	\$ 82	56	121	127
Subordinated debenture I	1,271	1,310	1,143	1,169
Subordinated debenture II	889	912	797	819
Mortgage loan payable	<u>180</u>	<u>176</u>	<u>162</u>	<u>157</u>
Total	\$ <u>2,422</u>	<u>2,454</u>	<u>2,223</u>	<u>2,272</u>

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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#### (13) Shareholders' Equity

The Company has authorized 12,500,000 shares of common stock, par value \$.10 per share (the "Common Stock"). Of the authorized shares of Common Stock, 5,560,232 shares were issued and 5,078,114 shares outstanding, and 5,384,232 shares were issued and 4,902,114 shares were outstanding as of December 31, 2017 and 2016, respectively. At December 31, 2017 and 2016, the Company held 482,118 shares as treasury stock, respectively.

At December 31, 2017, Goff Moore Strategic Partners, LP ("GMSP") owned approximately 33% of the outstanding Common Stock, James R. Reis owned approximately 13% and Robert W. Stallings owned approximately 27% of the outstanding Common Stock. At December 31, 2016, Goff Moore Strategic Partners, LP ("GMSP") owned approximately 34% of the outstanding Common Stock, James R. Reis owned approximately 13% and Robert W. Stallings owned approximately 26% of the outstanding Common Stock.

On August 7, 2017, the Company announced that its Board of Directors approved a special cash dividend of \$1.50 per share (\$7,617,171). The special cash dividend was paid on August 30, 2017 to shareholders of record on August 18, 2017 and was charged to Additional paid-in capital. On June 29, 2016, the Company announced that its Board of Directors approved a special cash dividend of \$2.50 per share (\$12,267,250). The special cash dividend was paid on July 19, 2016 to shareholders of record on July 11, 2016 and was charged to Additional paid-in capital.

The following table reflects changes in the number of shares of Common Stock outstanding for the years ended December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Shares outstanding		
Balance at beginning of period	4,902,114	4,860,900
Shares issued	176,000	46,000
Shares repurchased	<u>-</u>	<u>(4,786)</u>
Balance at end of period	<u>5,078,114</u>	<u>4,902,114</u>

In December 2015, the Board of Directors of the Company authorized a new share repurchase plan. Under this plan, the Company was authorized to purchase up to 1.5 million shares of the Company's Common Stock, at a price per share not to exceed \$15.00, in private negotiated transactions with stockholders that express an interest in selling their shares to the Company.

**GAINSCO, INC. AND SUBSIDIARIES**

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Under the terms of the December 2015 plan, the Company made the following repurchases:

ISSUER PURCHASES OF EQUITY SECURITIES				
	(a)	(b)	(c)	(d)
Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased Under the Authorized Plans or Programs	Amount of Shares that May Yet Be Purchased Under the Plans or Programs
10/01/2016 – 10/31/2016	4,786	\$13.250	4,786	1,495,214
Total	4,786	\$13.250	4,786	1,495,214

In April 2017, the Board of Directors of the Company terminated the December 2015 share repurchase plan and authorized a new share repurchase plan. Under the new plan, management was authorized to purchase up to 500,000 additional shares of the Company's Common Stock plus the shares not repurchased under the December 2015 plan, at a price per share not to exceed \$18.00. There had not been any repurchases under the new plan as of and for the year ended December 31, 2017.

The following table presents the statutory policyholders' surplus for MGA as of December 31, 2017 and 2016, and the statutory net income for MGA for the year ended December 31, 2017 and 2016:

		<u>2017</u>	<u>2016</u>
(Amounts in thousands)			
Statutory policyholders' surplus	\$	<u>107,338</u>	<u>103,305</u>
Statutory net income	\$	<u>18,077</u>	<u>12,933</u>

Statutes in Texas restrict the payment of dividends by MGA for any 12 month period to the greater of net income for the preceding year or 10% of surplus as regards policyholders as of the preceding December 31. This amount cannot be greater than unassigned funds (surplus) as of the preceding December 31. At December 31, 2017, \$12,844,000 is available for dividend payments next March or later, and MGA can pay an additional \$5,233,000 in December 2018. Dividends can be paid with regulatory notification of no objection from the Texas Department of Insurance.

## GAINSCO, INC. AND SUBSIDIARIES

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The Company's statutory capital exceeds the benchmark capital level under the Risk Based Capital ("RBC") formula for the insurance company. RBC is a method for establishing the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. As of December 31, 2017, the Company's RBC authorized control level was \$17,606,000 and the total adjusted capital was \$107,338,000.

#### (14) Earnings Per Share

The following table sets forth the computation of basic and diluted income per share (amounts in thousands, except for per share data):

	<u>Years ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
<u>Numerator:</u>		
Net income	\$ <u>11,692</u>	<u>11,991</u>
Numerator for basic earnings per share – income available to common shareholders	<u>11,692</u>	<u>11,991</u>
Numerator for diluted earnings per share – income available to common shareholders after assumed conversions	\$ <u>11,692</u>	<u>11,991</u>
<u>Denominator:</u>		
Denominator for basic earnings per share – weighted average common shares outstanding	<u>5,005</u>	<u>4,887</u>
Denominator for diluted earnings per share – adjusted weighted average common shares outstanding & assumed conversions	<u>5,005</u>	<u>4,887</u>
Basic earnings per share	\$ <u><u>2.34</u></u>	<u><u>2.45</u></u>
Diluted earnings per share	\$ <u><u>2.34</u></u>	<u><u>2.45</u></u>

#### (15) Benefits

The Company has a 401(k) plan for the benefit of its eligible employees. The Company made contributions to the plan that totaled \$486,000 and \$438,000 for 2017 and 2016, respectively.

As an integral part of the recapitalization consummated in January 2005, the Company entered into new employment agreements with Messrs. Stallings and Reis and an amended employment and related agreements with Mr. Glenn W. Anderson, which were approved by shareholders on January 18, 2005. Effective September 2015, the Company amended Mr. Anderson's agreement solely to change his base annual salary, and amended and restated the employment agreements with Messrs. Stallings and Reis to change their base annual salaries and to align their agreements more closely with Mr. Anderson's agreement.

## GAINSCO, INC. AND SUBSIDIARIES

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The terms of the employment agreements with Messrs. Stallings and Reis are each three years, and are automatically renewed for successive one year terms on the same terms and conditions on each anniversary of the effective date, unless either party gives notice of an intention not to renew.

The term of Mr. Anderson's employment is four years and is automatically extended by an additional year on the same terms and conditions on each anniversary of the effective date (so that, as of each anniversary of the effective date, the term of the employment agreement remains four years), unless either party gives notice of an intention not to extend the term.

The Company entered into an executive severance agreement in 2002 with Daniel J. Coots. The agreement generally provides that the Company shall pay the executive, upon termination of the employment of the executive by the Company without cause or by the executive with good reason during the term of the agreement, a lump sum severance amount equal to the base annual salary of the executive as of the date that the executive's employment with the Company ends. The executive severance agreement does not supersede change in control agreements or any other severance agreements the employee may have with the Company.

The Company entered into an executive severance agreement in October 2015 with Drew F. Nachowiak, the General Counsel of the Company. The agreement generally provides that the Company shall pay the executive, upon termination of the employment of the executive by the Company without cause or by the executive with good reason during the term of the agreement, an amount equal to the base annual salary of the executive as of the date that the executive's employment with the Company ends. Such amount is payable over a 12 month period. The executive severance agreement does not supersede a change in control agreement or any other severance agreement the employee may have with the Company.

In 2011 the Company instituted a deferred compensation plan for certain key employees. This plan had a five-year performance period with annual performance objectives based on the Company achieving minimum gross premiums written targets in 2012 through 2015 and target operating earnings before tax in 2011 through 2015. In 2016, this deferred compensation plan was amended for all participants to recalibrate the performance targets, as permitted by the agreements. In 2017, this deferred compensation plan was further amended for all participants to add an additional year (2020) and to recalibrate the performance targets, as permitted by the agreements. The amended plan agreements have a five-year performance period from 2016 through 2020 with annual performance objectives based on the Company achieving minimum gross premiums written targets and target operating earnings before tax (attributable to the private passenger automobile insurance business, as determined per the agreement). Compensation expense is recognized based on achieving individual year performance targets or on achieving cumulative performance results. Based on the results of the 2017 and 2016 fiscal year, compensation expense was recorded in the amount of \$1,275,000 and \$1,122,000, respectively.



## GAINSCO, INC. AND SUBSIDIARIES

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The compensation is recognized as an expense in the current year and deferred for payment five years later under terms of the plan. In addition, during 2015 separate deferred compensation agreements were entered into with certain designated key staff employees. Compensation pursuant to these agreements is recognized based on the key individual continuing each year in that designated key employee capacity. The compensation is recognized as expense in the current year and deferred for payment five years later under the terms of the plan. Based on the results of the 2017 and 2016 fiscal year, compensation expense was recorded in the amount of \$130,000 and \$105,000, respectively.

In the second quarter of 2017, the Board of Directors granted stock awards totaling 166,000 shares to five of the Company's officers. The awards were fully vested upon grant and \$2,863,500 was recognized as compensation expense in Underwriting and operating expense based on fair value of \$17.25 per share, which was the closing price of our Common Stock on the date of grant. Additionally, the Board of Directors granted stock awards totaling 10,000 shares to the two independent directors of the Company. The awards were fully vested upon grant and \$172,500 was recognized as director fees expense in Underwriting and operating expense based on fair value of \$17.25 per share, which was the closing price of our Common Stock on the date of grant.

In the second quarter of 2016, the Board of Directors granted stock awards totaling 42,000 shares to five of the Company's officers. The awards were fully vested upon grant and \$580,000 was recognized as compensation expense in Underwriting and operating expense based on fair value of \$13.80 per share, which was the closing price of our Common Stock on the date of grant. Additionally, the Board of Directors granted stock awards totaling 4,000 shares to the two independent directors of the Company. The awards were fully vested upon grant and \$55,000 was recognized as director fees expense in Underwriting and operating expense based on fair value of \$13.80 per share, which was the closing price of our Common Stock on the date of grant.

#### **(16) Commitments and Contingencies**

##### *Legal Proceedings*

In the normal course of their operations, the Company and its subsidiaries are named as defendants in various legal actions seeking monetary damages, including cases involving business disputes and those involving allegations that MGA wrongfully denied insurance claims and is liable for damages. Some cases involving insurance claims seek amounts significantly in excess of our policy limits. In the opinion of the Company's management, based on the information currently available, the ultimate liability, if any, resulting from the disposition of such litigation will not have a material adverse effect on the Company's consolidated financial position or results of operations. However, in view of the uncertainties inherent in such litigation, it is possible that the ultimate cost to the Company might exceed the reserves we have established by amounts that could have a material adverse effect on the Company's future results of operations, financial condition and cash flows in a particular reporting period.

## GAINSCO, INC. AND SUBSIDIARIES

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In August 2012, a policyholder of MGA was involved in an auto accident in Georgia resulting in medical treatment for the claimant. Following the accident, MGA received a demand to settle the matter for its policyholder's available limits of liability, \$25,000. MGA retained defense counsel to oversee conclusion of the settlement following MGA's oral acceptance of the settlement demand. The defense firm apparently failed to finalize the settlement within the time period required by claimant's written demand. As a result, MGA's tender of policy limits was rejected by the plaintiff's counsel, and a suit was filed against the policyholder. In March 2017, the case was tried, and the plaintiff received a jury verdict against MGA's insured in the amount of \$700,000. MGA filed an appeal of the judgment on behalf of its insured, and oral arguments on the appeal were heard in December 2017. A ruling by the appellate court is expected shortly. No claim has been brought against MGA at this time. While such litigation is inherently unpredictable, MGA believes that the judgment is without merit and it continues to defend its insured vigorously. As a result, MGA is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

In May 2011, a policyholder of MGA was involved in an auto accident in New Mexico resulting in medical treatment for the claimant. Following the accident, MGA requested medical records from the claimant, but received only some of them. Upon finally receiving sufficient medical information, MGA offered to settle the matter with the claimant for its policyholder's available limits of liability, \$25,000. MGA's offer was rejected by the claimant, and a suit was filed against the policyholder. In January 2014, the case was tried and the plaintiff received a jury verdict against MGA's insured in the amount of \$760,000 (\$360,000 in compensatory damages and \$400,000 in punitive damages). MGA's auto insurance policy specifically excluded liability for punitive damages. In March 2017, MGA's insured partially assigned to the claimant his interest in a claim against MGA and his defense counsel. The claimant then filed suit against MGA and the defense counsel. MGA filed an answer to the plaintiff's suit, and the case is in the discovery phase. MGA's errors and omissions insurance carrier has accepted the defense of the claim. Court-ordered mediation of this case is scheduled to occur in May 2018. While such litigation is inherently unpredictable, MGA believes that the complaint against it is without merit and continues to defend itself vigorously. As a result, MGA is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

In November 2016, the son of an MGA policyholder was involved in an accident with a motorcyclist in Georgia. The motorcyclist sustained injuries, and his right leg was partially amputated shortly thereafter. MGA completed its coverage assessment, determining that coverage conditions had been met and assessed MGA's insured as 100% liable. On May 22, 2017, MGA received the claimant's 30 day demand to settle for the policy limits, \$25,000. The MGA adjuster apparently miscalculated the due date by one day and sent the settlement check and acceptance letter via overnight delivery on June 22, 2017. Claimant's counsel rejected the attempted settlement acceptance and filed suit against MGA's insured. MGA filed an answer to the plaintiff's suit on behalf of its insured, and the case is in the discovery phase. MGA's errors and omissions insurance carrier has accepted the defense of the claim. Mediation of this case is scheduled to occur in June 2018. While such litigation is inherently unpredictable, MGA believes that the complaint against its insured is without merit and continues to defend its insured vigorously. As a result, MGA is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

In October 2017 MGA was served with a purported class action lawsuit filed against it in state court in Miami-Dade County, Florida. This suit is one of many filed by the plaintiff or its related entities in the last couple of years at both the state and federal levels against numerous auto insurance companies. The plaintiff, MSP Recovery Claims, Series LLC, is an entity created by the plaintiff's counsel to bring actions such as this one. The plaintiff is a purported assignee of one or more Medicare Advantage Organizations ("MAOs"), which allegedly paid medical expenses on behalf of Medicare beneficiaries who entered into settlements with MGA for bodily injuries sustained in automobile accidents involving MGA's insureds. Under the Medicare Secondary Payer ("MSP") laws, MAOs are secondary payers for medical expenses that are also covered by an insurance policy. The plaintiff alleges that MGA failed to reimburse the MAOs for payments made by the MAOs for which MGA was the primary payer under the MSP laws. MGA, as part of its claims review process, inquires whether an injured party is Medicare eligible and, if the party indicates that he or she is, the injured party's identifying information is transmitted to the Centers for Medicare and Medicaid Services. MGA filed a motion to dismiss this lawsuit in November 2017, and the motion is pending. MGA's errors and omissions insurance carrier has accepted the defense of the claim. While such litigation is inherently unpredictable, MGA believes that the complaint against it is without merit and continues to defend itself vigorously. As a result, MGA is unable to reasonably estimate a possible range of losses, if any, arising from the litigation.

#### *Off-balance-sheet-risk*

The Company does not have any financial instruments where there is off-balance-sheet-risk of accounting loss due to credit or market risk. There is credit risk in the premiums receivable and reinsurance balances receivable of the Company. At December 31, 2017 and 2016, the Company did not have any claims receivables by individual reinsurers that were material with regard to shareholders' equity.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

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#### (17) Leases

The Company entered into a ten-year lease agreement for the home office in May of 2005. After the Company amended the lease in 2017, a total of 86,516 square feet of office space were leased extending the lease a year until September 2027. Under the terms of this lease, the Company has the option of terminating the lease agreement at the end of September 2023, subject to payment of a penalty. The Company entered into an eleven-year lease agreement for the Florida office in May of 2010 that includes rentable office space of 22,480 square feet. Under the terms of this lease, the Company has the option of renewing for two additional five year periods through the year 2031. The Company also has the option of terminating the lease agreement during the sixth year of the term subject to payment of a penalty.

The following table summarizes the Company's lease obligations as of December 31, 2017 (amounts in thousands).

Year	Amount
2018	\$ 3,747
2019	3,459
2020	3,296
2021	2,932
2022	2,770
Thereafter	<u>11,458</u>
Total	\$ <u>27,662</u>

Rental expense is recognized over the term of the lease on a straight line basis for the Florida and the dealership leases only and the home office is expensed as incurred. Rental expense for the Company was \$2,938,000 and \$2,860,000 for the years ended December 31, 2017 and 2016, respectively.

## GAINSCO, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

#### **(18) Transactions with Related Persons**

The Company has evaluated transactions with related persons from the balance sheet date through May 3, 2018, the date at which the consolidated financial statements were available to be issued, and determined that there are no other items to disclose.

#### **(19) Subsequent Events**

##### *Stock Repurchase Plan*

In February 2018, the Board of Directors of the Company terminated the April 2017 share repurchase plan and authorized a new share repurchase plan. Under the new plan, the Company is authorized to purchase up to 1,200,000 shares of the Company's Common Stock, at a price per share not to exceed \$20.00.

The Company has evaluated subsequent events from the balance sheet date through May 3, 2018, the date at which the consolidated financial statements were available to be issued, and determined that there are no other items to disclose.