

KINGSTONE COMPANIES, INC.

Form 10-Q

November 14, 2012

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

FORM 10-Q

(Mark one)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

OR

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

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

Commission File Number 0-1665

KINGSTONE COMPANIES, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of  
incorporation or organization)

36-2476480

(I.R.S. Employer  
Identification Number)

1154 Broadway  
Hewlett, NY 11557

(Address of principal executive offices)

(516) 374-7600

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of November 14, 2012, there were 3,842,869 shares of the registrant's common stock outstanding.

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KINGSTONE COMPANIES, INC.

## INDEX

|   | PAGE |
|---|------|
| <b>PART I — FINANCIAL INFORMATION</b>   |      |
| Item 1 —  | 3    |
| Financial Statements  |      |
| Condensed Consolidated Balance Sheets at September 30, 2012 (Unaudited) and December 31, 2011   | 3    |
| Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 (Unaudited) and 2011 (Unaudited) | 4    |
| Condensed Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2012 (Unaudited)                                 | 5    |
| Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 (Unaudited) and 2011 (Unaudited)                     | 6    |
| Notes to Condensed Consolidated Financial Statements (Unaudited)  | 7    |
| Management's Discussion and Analysis of Financial Condition and Results of Operations   | 27   |
| Item 2 —  | 27   |
| Item 3 —  | 45   |
| Item 4 —  | 45   |
| Quantitative and Qualitative Disclosures About Market Risk  |      |
| Controls and Procedures   |      |
| <b>PART II — OTHER INFORMATION</b>  |      |
| Item 1 —  | 46   |
| Legal Proceedings   |      |
| Item 1A —   | 46   |
| Risk Factors  |      |
| Item 2 —  | 46   |
| Unregistered Sales of Equity Securities and Use of Proceeds   |      |
| Item 3 —  | 46   |
| Defaults Upon Senior Securities   |      |
| Item 4 —  | 46   |
| Mine Safety Disclosures   |      |
| Item 5 —  | 46   |
| Other Information   |      |
| Item 6 —  | 46   |
| Exhibits  |      |
| Signatures  |      |
| EXHIBIT 3(a)  |      |
| EXHIBIT 3(b)  |      |
| EXHIBIT 31(a)   |      |
| EXHIBIT 31(b)   |      |
| EXHIBIT 32  |      |
| EXHIBIT 101.INS XBRL Instance Document  |      |
| EXHIBIT 101.SCH XBRL Taxonomy Extension Schema  |      |
| EXHIBIT 101.CAL XBRL Taxonomy Extension Calculation Linkbase  |      |
| EXHIBIT 101.DEF XBRL Taxonomy Extension Definition Linkbase   |      |
| EXHIBIT 101.LAB XBRL Taxonomy Extension Label Linkbase  |      |
| EXHIBIT 101.PRE XBRL Taxonomy Extension Presentation Linkbase   |      |

## Forward-Looking Statements

This Quarterly Report contains forward-looking statements as that term is defined in the federal securities laws. The events described in forward-looking statements contained in this Quarterly Report may not occur. Generally these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of our plans or strategies, projected or anticipated benefits from acquisitions to be made by us, or projections involving anticipated revenues, earnings or other aspects of our operating results. The words "may," "will," "expect," "believe," "anticipate," "project," "plan," "intend," "estimate," and "continue," and their opposites and similar expressions are intended to identify forward-looking statements. We caution you that these statements are not guarantees of future performance or events and are subject to a number of uncertainties, risks and other influences, many of which are beyond our control, that may influence the accuracy of the statements and the projections upon which the statements are based. Factors which may affect our results include, but are not limited to, the risks and uncertainties discussed in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011 under "Factors That May Affect Future Results and Financial Condition".

Any one or more of these uncertainties, risks and other influences could materially affect our results of operations and whether forward-looking statements made by us ultimately prove to be accurate. Our actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether from new information, future events or otherwise.

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

## KINGSTONE COMPANIES, INC. AND SUBSIDIARIES

## Condensed Consolidated Balance Sheets

|   | September<br>30,<br>2012<br>(unaudited) | December<br>31,<br>2011 |
|---|---|-------------------------|
| <b>Assets</b>   |   |                         |
| Fixed-maturity securities, held to maturity, at amortized cost (fair value of \$792,101 at September 30, 2012 and \$777,953 at December 31, 2011)         | \$606,273                               | \$606,234               |
| Fixed-maturity securities, available for sale, at fair value (amortized cost of \$21,780,082 at September 30, 2012 and \$22,215,191 at December 31, 2011) | 23,102,130                              | 22,568,932              |
| Equity securities, available-for-sale, at fair value (cost of \$4,716,098 at September 30, 2012 and \$3,857,741 at December 31, 2011)                     | 5,230,893                               | 4,065,210               |
| Total investments   | 28,939,296                              | 27,240,376              |
| Cash and cash equivalents   | 2,447,849                               | 173,126                 |
| Premiums receivable, net of provision for uncollectible amounts   | 6,854,026                               | 5,779,085               |
| Receivables - reinsurance contracts   | 2,668,123                               | 1,734,535               |
| Reinsurance receivables, net of provision for uncollectible amounts   | 28,047,484                              | 23,880,814              |
| Notes receivable-sale of business   | 331,207                                 | 393,511                 |
| Deferred acquisition costs  | 5,397,647                               | 4,535,773               |
| Intangible assets, net  | 3,303,886                               | 3,660,672               |
| Property and equipment, net of accumulated depreciation   | 1,640,464                               | 1,646,341               |
| Other assets  | 895,269                                 | 660,672                 |
| Total assets  | \$80,525,251                            | \$69,704,905            |
| <b>Liabilities</b>  |   |                         |
| Loss and loss adjustment expenses   | \$22,283,145                            | \$18,480,717            |
| Unearned premiums   | 25,309,496                              | 21,283,160              |
| Advance premiums  | 497,273                                 | 544,791                 |
| Reinsurance balances payable  | 3,164,848                               | 2,761,828               |
| Deferred ceding commission revenue  | 4,662,272                               | 3,982,399               |
| Notes payable (includes payable to related parties of \$378,000 at September 30, 2012 and December 31, 2011)  | 1,097,000                               | 1,047,000               |
| Accounts payable, accrued expenses and other liabilities  | 3,404,982                               | 4,505,016               |
| Deferred income taxes   | 2,011,122                               | 1,789,439               |
| Total liabilities   | 62,430,138                              | 54,394,350              |
| <b>Commitments and Contingencies</b>  |   |                         |
| <b>Stockholders' Equity</b>   |   |                         |
| Common stock, \$.01 par value; authorized 10,000,000 shares; issued 4,715,829 shares at September 30, 2012 and 4,643,122 shares at December 31, 2011;     |   |                         |

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|   |              |              |
|---|--------------|--------------|
| outstanding 3,828,391 shares at September 30, 2012 and 3,759,900 shares at December 31, 2011          | 47,159       | 46,432       |
| Preferred stock, \$.01 par value; authorized 1,000,000 shares; -0- shares issued and outstanding      | -            | -            |
| Capital in excess of par  | 13,839,741   | 13,739,792   |
| Accumulated other comprehensive income  | 1,212,316    | 370,399      |
| Retained earnings   | 4,414,024    | 2,554,349    |
|   | 19,513,240   | 16,710,972   |
| Treasury stock, at cost, 887,438 shares at September 30, 2012 and 883,222 shares at December 31, 2011 | (1,418,127 ) | (1,400,417 ) |
| Total stockholders' equity  | 18,095,113   | 15,310,555   |
| Total liabilities and stockholders' equity  | \$80,525,251 | \$69,704,905 |

See accompanying notes to condensed consolidated financial statements.

## KINGSTONE COMPANIES, INC. AND SUBSIDIARIES

## Condensed Consolidated Statements of Comprehensive Income (Unaudited)

|   | For the Three Months |               | For the Nine Months Ended |               |
|---|----------------------|---------------|---------------------------|---------------|
|   | Ended                |               | September 30,             |               |
|   | September 30,        | September 30, | September 30,             | September 30, |
|   | 2012                 | 2011          | 2012                      | 2011          |
| <b>Revenues</b>   |                      |               |                           |               |
| Net premiums earned   | \$5,281,701          | \$3,937,189   | \$13,418,808              | \$10,822,137  |
| Ceding commission revenue   | 2,711,431            | 2,307,390     | 8,525,945                 | 7,347,832     |
| Net investment income   | 242,159              | 172,039       | 739,555                   | 510,173       |
| Net realized gain on investments  | 65,986               | 196,574       | 111,546                   | 357,006       |
| Other income  | 218,723              | 228,615       | 680,469                   | 693,188       |
| Total revenues  | 8,520,000            | 6,841,807     | 23,476,323                | 19,730,336    |
| <b>Expenses</b>   |                      |               |                           |               |
| Loss and loss adjustment expenses   | 2,691,402            | 2,933,531     | 7,378,421                 | 7,307,925     |
| Commission expense  | 1,952,583            | 1,596,281     | 5,430,000                 | 4,472,924     |
| Other underwriting expenses   | 2,134,106            | 1,734,137     | 5,986,428                 | 5,045,051     |
| Other operating expenses  | 255,628              | 260,149       | 829,957                   | 863,114       |
| Depreciation and amortization   | 150,351              | 144,122       | 447,372                   | 457,264       |
| Interest expense  | 19,781               | 23,577        | 60,677                    | 108,249       |
| Total expenses  | 7,203,851            | 6,691,797     | 20,132,855                | 18,254,527    |
| Income from operations before taxes   | 1,316,149            | 150,010       | 3,343,468                 | 1,475,809     |
| Income tax expense (benefit)  | 402,162              | (69,559 )     | 1,103,747                 | 355,685       |
| Net income  | 913,987              | 219,569       | 2,239,721                 | 1,120,124     |
| Gross unrealized investment holding gains arising during period             | 533,877              | (166,793 )    | 1,275,632                 | 166,513       |
| Income tax (expense) benefit related to items of other comprehensive income | (181,518 )           | 56,710        | (433,715 )                | (56,614 )     |
| Comprehensive income  | \$1,266,346          | \$109,486     | \$3,081,638               | \$1,230,023   |
| <b>Earnings per common share:</b>   |                      |               |                           |               |
| Basic   | \$0.24               | \$0.06        | \$0.59                    | \$0.29        |
| Diluted   | \$0.23               | \$0.06        | \$0.59                    | \$0.29        |
| <b>Weighted average common shares outstanding</b>                           |                      |               |                           |               |
| Basic   | 3,824,461            | 3,838,386     | 3,794,979                 | 3,838,386     |
| Diluted   | 3,936,167            | 3,913,036     | 3,884,172                 | 3,838,386     |
| Dividends declared and paid per common share                                | \$0.04               | \$0.03        | \$0.10                    | \$0.03        |

See accompanying notes to condensed consolidated financial statements.





## KINGSTONE COMPANIES, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders' Equity  
Nine months ended September 30, 2012 (unaudited)

|  | Common Stock<br>Shares | Common Stock<br>Amount | Preferred<br>Stock<br>Shares | Preferred<br>Stock<br>Amount | Capital<br>in Excess<br>of Par | Accumulated<br>Other<br>Comprehensive<br>Income | Retained<br>Earnings | Treasury Stock<br>Shares | Treasury Stock<br>Amount | Total        |
|--|------------------------|------------------------|------------------------------|------------------------------|--------------------------------|---|----------------------|--------------------------|--------------------------|--------------|
| Balance,<br>December 31,<br>2011   | 4,643,122              | 46,432                 | -                            | -                            | 13,739,792                     | 370,399   | 2,554,349            | 883,222                  | (1,400,417)              | 15,310,555   |
| Stock-based<br>compensation  | -                      | -                      | -                            | -                            | 39,125                         | -   | -                    | -                        | -                        | 39,125       |
| Exercise of<br>stock options   | 90,985                 | 910                    | -                            | -                            | 46,164                         | -   | -                    | -                        | -                        | 47,074       |
| Shares<br>deducted from<br>exercise of<br>stock options<br>for payment<br>of<br>withholding<br>taxes | (18,278 )              | (183 )                 | -                            | -                            | (103,410 )                     | -   | -                    | -                        | -                        | (103,593)    |
| Tax benefit<br>from exercise<br>of stock<br>options  | -                      | -                      | -                            | -                            | 118,070                        | -   | -                    | -                        | -                        | 118,070      |
| Acquisition of<br>treasury stock   | -                      | -                      | -                            | -                            | -                              | -   | -                    | 4,216                    | (17,710 )                | (17,710)     |
| Dividends  | -                      | -                      | -                            | -                            | -                              | -   | (380,046 )           | -                        | -                        | (380,046)    |
| Net income   | -                      | -                      | -                            | -                            | -                              | -   | 2,239,721            | -                        | -                        | 2,239,721    |
| Change in<br>unrealized<br>gains on<br>available for<br>sale securities,<br>net of tax               | -                      | -                      | -                            | -                            | -                              | 841,917   | -                    | -                        | -                        | 841,917      |
| Balance,<br>September 30,<br>2012  | 4,715,829              | \$47,159               | -                            | \$-                          | \$13,839,741                   | \$1,212,316                                     | \$4,414,024          | 887,438                  | \$(1,418,127)            | \$18,095,113 |

See accompanying notes to condensed consolidated financial statements.



## KINGSTONE COMPANIES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows  
(Unaudited)

| Nine months ended September 30,  | 2012         | 2011         |
|--|--------------|--------------|
| Cash flows provided by operating activities:                                 |              |              |
| Net income   | \$ 2,239,721 | \$ 1,120,124 |
| Adjustments to reconcile net income to net cash provided by operations:      |              |              |
| Gain on sale of investments  | (111,545 )   | (357,006 )   |
| Depreciation and amortization  | 447,372      | 457,264      |
| Amortization of bond premium, net  | 88,127       | 162,990      |
| Stock-based compensation   | 39,125       | 85,571       |
| Deferred income tax expense  | (212,032 )   | (402,447 )   |
| (Increase) decrease in assets:   |              |              |
| Premiums receivable, net   | (1,074,941 ) | (1,036,447 ) |
| Receivables - reinsurance contracts  | (933,588 )   | 489,413      |
| Reinsurance receivables, net   | (4,166,670 ) | (4,923,362 ) |
| Deferred acquisition costs   | (861,874 )   | (796,055 )   |
| Other assets   | (264,712 )   | 860,804      |
| Increase (decrease) in liabilities:  |              |              |
| Loss and loss adjustment expenses  | 3,802,428    | 3,661,655    |
| Unearned premiums  | 4,026,336    | 3,824,216    |
| Advance premiums   | (47,518 )    | 226,783      |
| Reinsurance balances payable   | 403,020      | 1,815,918    |
| Deferred ceding commission revenue   | 679,873      | 638,307      |
| Accounts payable, accrued expenses and other liabilities                     | (1,100,034 ) | (37,087 )    |
| Net cash flows provided by operating activities                              | 2,953,088    | 5,790,641    |
| Cash flows used in investing activities:                                     |              |              |
| Purchase - fixed-maturity securities available for sale                      | (2,264,507 ) | (4,372,917 ) |
| Purchase - equity securities   | (1,873,253 ) | (2,570,333 ) |
| Sale or maturity - fixed-maturity securities available for sale              | 2,766,758    | 3,034,295    |
| Sale - equity securities   | 1,001,247    | 1,362,700    |
| Recovery of loss from failed bank  | -            | 133,211      |
| Collections of notes receivable and accrued interest - sale of businesses    | 62,304       | 304,602      |
| Other investing activities   | (84,709 )    | (148,601 )   |
| Net cash flows used in investing activities                                  | (392,160 )   | (2,257,043 ) |
| Cash flows used in financing activities:                                     |              |              |
| Proceeds from line of credit   | 465,000      | -            |
| Principal payments on line of credit   | (415,000 )   | -            |
| Principal payments on long-term debt (includes \$407,000 to related parties) | -            | (713,997 )   |

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|  |              |              |
|--|--------------|--------------|
| Proceeds from exercise of stock options                      | 47,074       | -            |
| Withholding taxes paid on cashless exercise of stock options | (103,593 )   | -            |
| Tax benefit from exercise of stock options                   | 118,070      | -            |
| Purchase of treasury stock                                   | (17,710 )    | -            |
| Dividends paid   | (380,046 )   | (115,153 )   |
| Net cash flows used in financing activities                  | (286,205 )   | (829,150 )   |
| Increase in cash and cash equivalents                        | \$ 2,274,723 | \$ 2,704,448 |
| Cash and cash equivalents, beginning of period               | 173,126      | 326,620      |
| Cash and cash equivalents, end of period                     | \$ 2,447,849 | \$ 3,031,068 |
| Supplemental disclosures of cash flow information:           |              |              |
| Cash paid for income taxes                                   | \$ 1,853,000 | \$ 458,871   |
| Cash paid for interest                                       | \$ 78,122    | \$ 172,964   |

See accompanying notes to condensed consolidated financial statements.

KINGSTONE COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1 - Basis of Presentation and Nature of Business

Kingstone Companies, Inc. (referred to herein as "Kingstone" or the "Company"), through its subsidiary, Kingstone Insurance Company ("KICO"), underwrites property and casualty insurance to small businesses and individuals exclusively through independent agents and brokers. KICO is a licensed insurance company in the State of New York. In February 2011, KICO's application for an insurance license to write insurance in the Commonwealth of Pennsylvania was approved; however, KICO has only nominally commenced writing business in Pennsylvania. Kingstone, through its subsidiary, Payments, Inc., a licensed premium finance company in the State of New York, receives fees for placing contracts with a third party licensed premium finance company.

The accompanying unaudited condensed consolidated financial statements included in this report have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and the instructions to Securities and Exchange Commission ("SEC") Form 10-Q and Article 8-03 of SEC Regulation S-X. The principles for condensed interim financial information do not require the inclusion of all the information and footnotes required by generally accepted accounting principles for complete financial statements. Therefore, these financial statements should be read in conjunction with the consolidated financial statements as of and for the year ended December 31, 2011 and notes thereto included in the Company's Annual Report on Form 10-K filed on March 30, 2012. The accompanying condensed consolidated financial statements have not been audited by an independent registered public accounting firm in accordance with standards of the Public Company Accounting Oversight Board (United States) but, in the opinion of management, such financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the Company's financial position and results of operations. The results of operations for the nine months ended September 30, 2012 may not be indicative of the results that may be expected for the year ending December 31, 2012.

Note 2 – Accounting Policies and Basis of Presentation

Use of Estimates

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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions, which include the reserves for losses and loss adjustment expenses, are subject to considerable estimation error due to the inherent uncertainty in projecting ultimate claim amounts that will be reported and settled over a period of several years. In addition, estimates and assumptions associated with receivables under reinsurance contracts related to contingent ceding commission revenue require considerable judgment by management. On an on-going basis, management reevaluates its assumptions and the methods of calculating its estimates. Actual results may differ significantly from the estimates and assumptions used in preparing the consolidated financial statements.

Principles of Consolidation

The consolidated financial statements consist of Kingstone and its wholly-owned subsidiaries. Subsidiaries include KICO and its subsidiaries, CMIC Properties, Inc. ("Properties") and 15 Joys Lane, LLC ("15 Joys Lane"), which together own the land and building from which KICO operates. All significant inter-company transactions have been

eliminated in consolidation.

7

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## Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (the “FASB”) issued ASU 2012-02, Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment, to simplify the guidance for testing the decline in the realizable value (impairment) of indefinite-lived intangible assets other than goodwill. Under this update, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an intangible asset is less than its carrying amount. If such a determination is not reached, then performance of further impairment testing is not necessary. The new guidance is effective for annual and interim goodwill tests performed for fiscal years beginning after September 15, 2012. However, early adoption is permitted. The adoption of ASU 2012-02 is not expected to have a material effect on the Company’s consolidated financial condition or results of operations.

In June 2011 (and as amended in December 2011), the FASB issued ASU No. 2011-05, “Presentation of Comprehensive Income” (“ASU 2011-05”). ASU 2011-05 provides amendments to ASC No. 220 “Comprehensive Income”, which require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments in this update are effective retrospectively for fiscal years and interim periods within those years, beginning after December 15, 2011, with early adoption permitted. The Company adopted this guidance effective January 1, 2012.

The Company has determined that all other recently issued accounting pronouncements will not have a material impact on its consolidated financial position, results of operations and cash flows, or do not apply to its operations.

## Note 3 - Investments

### Available for Sale Securities

The amortized cost and fair value of investments in available for sale fixed-maturity securities and equities as of September 30, 2012 and December 31, 2011 are summarized as follows:

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September 30, 2012

| Category   | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross Unrealized Losses                  |                           | Fair<br>Value       | Net<br>Unrealized<br>Gains/<br>(Losses) |
|--|------------------------------|------------------------------|--|---------------------------|---------------------|---|
|  |                              |                              | Less than<br>12<br>Months<br>(unaudited) | More than<br>12<br>Months |                     |   |
| <b>Fixed-Maturity Securities:</b>                                    |                              |                              |  |                           |                     |   |
| <b>Political subdivisions of States, Territories and Possessions</b> |                              |                              |  |                           |                     |   |
|  | \$5,568,774                  | \$290,672                    | \$-                                      | \$(40,055)                | \$5,819,391         | \$250,617                               |
| <b>Corporate and other bonds</b>                                     |                              |                              |  |                           |                     |   |
| Industrial and miscellaneous   | 16,211,308                   | 1,085,116                    | (5,348)                                  | (8,337)                   | 17,282,739          | 1,071,431                               |
| <b>Total fixed-maturity securities</b>                               | <b>21,780,082</b>            | <b>1,375,788</b>             | <b>(5,348)</b>                           | <b>(48,392)</b>           | <b>23,102,130</b>   | <b>1,322,048</b>                        |
| <b>Equity Securities:</b>  |                              |                              |  |                           |                     |   |
| Preferred stocks   | 1,453,688                    | 44,552                       | (8,977)                                  | -                         | 1,489,263           | 35,575                                  |
| Common stocks  | 3,262,410                    | 505,609                      | (26,389)                                 | -                         | 3,741,630           | 479,220                                 |
| <b>Total equity securities</b>                                       | <b>4,716,098</b>             | <b>550,161</b>               | <b>(35,366)</b>                          | <b>-</b>                  | <b>5,230,893</b>    | <b>514,795</b>                          |
| <b>Total</b>   | <b>\$26,496,180</b>          | <b>\$1,925,949</b>           | <b>\$(40,714)</b>                        | <b>\$(48,392)</b>         | <b>\$28,333,023</b> | <b>\$1,836,843</b>                      |

December 31, 2011

| Category   | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross Unrealized Losses   |                           | Fair<br>Value | Net<br>Unrealized<br>Gains/<br>(Losses) |
|--|------------------------------|------------------------------|---------------------------|---------------------------|---------------|---|
|  |                              |                              | Less than<br>12<br>Months | More than<br>12<br>Months |               |   |
| <b>Fixed-Maturity Securities:</b>  |                              |                              |                           |                           |               |   |
| <b>U.S. Treasury securities and obligations of U.S. government corporations and agencies</b> |                              |                              |                           |                           |               |   |
|  | \$ 499,832                   | \$ 50,356                    | \$ -                      | \$ -                      | \$ 550,188    | \$ 50,356                               |
| <b>Political subdivisions of States, Territories and Possessions</b>                         |                              |                              |                           |                           |               |   |
|  | 5,868,743                    | 301,559                      | -                         | -                         | 6,170,302     | 301,559                                 |
| <b>Corporate and other bonds</b>   |                              |                              |                           |                           |               |   |
| Industrial and miscellaneous   | 15,846,616                   | 338,284                      | (228,792)                 | (107,666)                 | 15,848,442    | 1,826                                   |



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|                                       |               |              |               |               |               |            |
|---------------------------------------|---------------|--------------|---------------|---------------|---------------|------------|
| Total<br>fixed-maturity<br>securities | 22,215,191    | 690,199      | (228,792 )    | (107,666 )    | 22,568,932    | 353,741    |
| Equity Securities:                    |               |              |               |               |               |            |
| Preferred stocks                      | 1,428,435     | 36,762       | (76,969 )     | (4,893 )      | 1,383,335     | (45,100 )  |
| Common stocks                         | 2,429,306     | 274,538      | (21,969 )     | -             | 2,681,875     | 252,569    |
| Total equity<br>securities            | 3,857,741     | 311,300      | (98,938 )     | (4,893 )      | 4,065,210     | 207,469    |
| Total                                 | \$ 26,072,932 | \$ 1,001,499 | \$ (327,730 ) | \$ (112,559 ) | \$ 26,634,142 | \$ 561,210 |

A summary of the amortized cost and fair value of the Company's investments in available for sale fixed-maturity securities by contractual maturity as of September 30, 2012 and December 31, 2011 is shown below:

| Remaining Time to Maturity | September 30, 2012   |                      | December 31, 2011    |                      |
|----------------------------|----------------------|----------------------|----------------------|----------------------|
|                            | Amortized Cost       | Fair Value           | Amortized Cost       | Fair Value           |
|                            | (unaudited)          |                      |                      |                      |
| Less than one year         | \$ 1,212,342         | \$ 1,179,180         | \$ 1,063,493         | \$ 1,079,924         |
| One to five years          | 7,523,680            | 7,967,410            | 6,899,892            | 7,045,774            |
| Five to ten years          | 11,909,521           | 12,760,814           | 12,547,046           | 12,680,441           |
| More than 10 years         | 1,134,539            | 1,194,726            | 1,704,760            | 1,762,793            |
| <b>Total</b>               | <b>\$ 21,780,082</b> | <b>\$ 23,102,130</b> | <b>\$ 22,215,191</b> | <b>\$ 22,568,932</b> |

The actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without penalties.

#### Held to Maturity Securities

The amortized cost and fair value of investments in held to maturity fixed-maturity securities as of September 30, 2012 and December 31, 2011 are summarized as follows:

| Category                 | September 30, 2012     |                        |                         |                     |            | Net Unrealized Gains/ (Losses) |
|--------------------------|------------------------|------------------------|-------------------------|---------------------|------------|--------------------------------|
|                          | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses |                     | Fair Value |                                |
|                          |                        |                        | Less than 12 Months     | More than 12 Months |            |                                |
|                          |                        |                        | (unaudited)             |                     |            |                                |
| U.S. Treasury securities | \$606,273              | \$185,828              | \$-                     | \$-                 | \$792,101  | \$185,828                      |

  

| Category                 | December 31, 2011      |                        |                         |                     |            | Net Unrealized Gains/ (Losses) |
|--------------------------|------------------------|------------------------|-------------------------|---------------------|------------|--------------------------------|
|                          | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses |                     | Fair Value |                                |
|                          |                        |                        | Less than 12 Months     | More than 12 Months |            |                                |
|                          |                        |                        |                         |                     |            |                                |
| U.S. Treasury securities | \$606,234              | \$171,719              | \$-                     | \$-                 | \$777,953  | \$171,719                      |

All held to maturity securities are held in trust pursuant to the New York State Department of Financial Services' minimum funds requirement.

Contractual maturities of all held to maturity securities are greater than ten years.

## Investment Income

Major categories of the Company's net investment income are summarized as follows:

|                           | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |            |
|---------------------------|-------------------------------------|------------|------------------------------------|------------|
|                           | 2012                                | 2011       | 2012                               | 2011       |
|                           | (unaudited)                         |            | (unaudited)                        |            |
| Income:                   |                                     |            |                                    |            |
| Fixed-maturity securities | \$ 249,315                          | \$ 170,083 | \$ 710,585                         | \$ 526,583 |
| Equity securities         | 49,279                              | 44,089     | 197,518                            | 114,387    |
| Cash and cash equivalents | 25                                  | 2,552      | 84                                 | 4,775      |
| Other                     | 2                                   | 8          | 6                                  | (3,307 )   |
| Total                     | 298,621                             | 216,732    | 908,193                            | 642,438    |
| Expenses:                 |                                     |            |                                    |            |
| Investment expenses       | 56,462                              | 44,693     | 168,638                            | 132,265    |
| Net investment income     | \$ 242,159                          | \$ 172,039 | \$ 739,555                         | \$ 510,173 |

Proceeds from the sale and maturity of fixed-maturity securities were \$2,766,758 and \$3,034,295 for the nine months ended September 30, 2012 and 2011, respectively.

Proceeds from the sale of equity securities were \$1,001,247 and \$1,362,700 for the nine months ended September 30, 2012 and 2011, respectively.

The Company's net realized gains and losses on investments are summarized as follows:

|                                     | Three months ended<br>September 30, |           | Nine months ended<br>September 30, |           |
|-------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                     | 2012                                | 2011      | 2012                               | 2011      |
|                                     | (unaudited)                         |           | (unaudited)                        |           |
| Fixed-maturity securities:          |                                     |           |                                    |           |
| Gross realized gains                | \$60,349                            | \$51,805  | \$153,695                          | \$139,107 |
| Gross realized losses               | -                                   | -         | (52,600 )                          | (1,983 )  |
|                                     | 60,349                              | 51,805    | 101,095                            | 137,124   |
| Equity securities:                  |                                     |           |                                    |           |
| Gross realized gains                | 7,735                               | 11,558    | 40,019                             | 147,375   |
| Gross realized losses               | (2,098 )                            | -         | (29,568 )                          | (60,704 ) |
|                                     | 5,637                               | 11,558    | 10,451                             | 86,671    |
| Cash and short term investments (1) |                                     |           |                                    |           |
|                                     | -                                   | 133,211   | -                                  | 133,211   |
| Net realized gains                  | \$65,986                            | \$196,574 | \$111,546                          | \$357,006 |

(1) Realized gain on cash and short term investments is a partial recovery from the FDIC of an amount previously written off in 2009 due to the failure of Waterfield Bank.



## Impairment Review

The Company regularly reviews its fixed-maturity securities and equity securities portfolios to evaluate the necessity of recording impairment losses for other-than-temporary investment (“OTTI”) declines in the fair value of investments. In evaluating potential impairment, management considers, among other criteria: (i) the current fair value compared to amortized cost or cost, as appropriate; (ii) the length of time the security’s fair value has been below amortized cost or cost; (iii) specific credit issues related to the issuer such as changes in credit rating, reduction or elimination of dividends or non-payment of scheduled interest payments; (iv) management’s intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in value to cost; and (v) current economic conditions.

OTTI losses are recorded in the condensed consolidated statement of operations and comprehensive income as net realized losses on investments and result in a permanent reduction of the cost basis of the underlying investment. The determination of OTTI is a subjective process and different judgments and assumptions could affect the timing of loss realization. There are 13 securities at September 30, 2012 that account for the gross unrealized loss. The Company determined that none of the unrealized losses were deemed to be OTTI for its portfolio of fixed maturity investments and equity securities for the nine months ended September 30, 2012 and 2011. Significant factors influencing the Company’s determination that unrealized losses were temporary included the magnitude of the unrealized losses in relation to each security’s cost, the nature of the investment and management’s intent and ability to retain the investment for a period of time sufficient to allow for anticipated recovery of fair value to the Company’s cost basis.

The Company held securities with unrealized losses representing declines that were considered temporary at September 30, 2012 and December 31, 2011 as follows:

| Category  | Less than 12 months |                   |                       | September 30, 2012<br>12 months or more |                   |                       | Total                |                   |
|---|---------------------|-------------------|-----------------------|---|-------------------|-----------------------|----------------------|-------------------|
|   | Fair Value          | Unrealized Losses | No. of Positions Held | Fair Value                              | Unrealized Losses | No. of Positions Held | Aggregate Fair Value | Unrealized Losses |
| (unaudited)   |                     |                   |                       |   |                   |                       |                      |                   |
| Fixed-Maturity Securities:                                    |                     |                   |                       |   |                   |                       |                      |                   |
| Political subdivisions of States, Territories and Possessions | \$-                 | \$ -              | -                     | \$764,668                               | \$ (40,055 )      | 2                     | \$764,668            | \$ (40,055 )      |
| Corporate and other bonds industrial and miscellaneous        | 877,005             | (5,348 )          | 3                     | 370,758                                 | (8,337 )          | 2                     | 1,247,763            | (13,685 )         |
| Total fixed-maturity securities                               | \$877,005           | \$ (5,348 )       | 3                     | \$1,135,426                             | \$ (48,392 )      | 4                     | \$2,012,431          | \$ (53,740 )      |
| Equity Securities:  |                     |                   |                       |   |                   |                       |                      |                   |
| Preferred stocks  | \$386,950           | \$ (8,977 )       | 3                     | \$-                                     | \$ -              | -                     | \$386,950            | \$ (8,977 )       |
| Common stocks   | 439,205             | (26,389 )         | 3                     | -                                       | -                 | -                     | 439,205              | (26,389 )         |
| Total equity securities                                       | \$826,155           | \$ (35,366 )      | 6                     | \$-                                     | \$ -              | -                     | \$826,155            | \$ (35,366 )      |

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|       |             |              |   |             |              |   |             |              |
|-------|-------------|--------------|---|-------------|--------------|---|-------------|--------------|
| Total | \$1,703,160 | \$ (40,714 ) | 9 | \$1,135,426 | \$ (48,392 ) | 4 | \$2,838,586 | \$ (89,106 ) |
|-------|-------------|--------------|---|-------------|--------------|---|-------------|--------------|

| Category | Less than 12 months |            |           | December 31, 2011<br>12 months or more |            |           | Total     |            |
|----------|---------------------|------------|-----------|--|------------|-----------|-----------|------------|
|          | Fair                | Unrealized | No. of    | Fair                                   | Unrealized | No. of    | Aggregate | Unrealized |
|          | Value               | Losses     | Positions | Value                                  | Losses     | Positions | Fair      | Losses     |
|          |                     |            | Held      |  |            | Held      | Value     |            |

Fixed-Maturity Securities:

|   |             |               |    |             |               |   |             |               |
|---|-------------|---------------|----|-------------|---------------|---|-------------|---------------|
| Corporate and other<br>bonds industrial<br>and<br>miscellaneous | \$4,849,378 | \$ (228,792 ) | 26 | \$1,483,425 | \$ (107,666 ) | 7 | \$6,332,803 | \$ (336,458 ) |
|---|-------------|---------------|----|-------------|---------------|---|-------------|---------------|

|                                       |             |               |    |             |               |   |             |               |
|---------------------------------------|-------------|---------------|----|-------------|---------------|---|-------------|---------------|
| Total<br>fixed-maturity<br>securities | \$4,849,378 | \$ (228,792 ) | 26 | \$1,483,425 | \$ (107,666 ) | 7 | \$6,332,803 | \$ (336,458 ) |
|---------------------------------------|-------------|---------------|----|-------------|---------------|---|-------------|---------------|

Equity Securities:

|                            |           |              |    |           |             |   |           |               |
|----------------------------|-----------|--------------|----|-----------|-------------|---|-----------|---------------|
| Preferred stocks           | \$368,350 | \$ (76,969 ) | 12 | \$189,364 | \$ (4,893 ) | 5 | \$557,714 | \$ (81,862 )  |
| Common stocks              | 397,268   | (21,969 )    | 14 | -         | -           | - | 397,268   | (21,969 )     |
| Total equity<br>securities | \$765,618 | \$ (98,938 ) | 26 | \$189,364 | \$ (4,893 ) | 5 | \$954,982 | \$ (103,831 ) |

|       |             |               |    |             |               |    |             |               |
|-------|-------------|---------------|----|-------------|---------------|----|-------------|---------------|
| Total | \$5,614,996 | \$ (327,730 ) | 52 | \$1,672,789 | \$ (112,559 ) | 12 | \$7,287,785 | \$ (440,289 ) |
|-------|-------------|---------------|----|-------------|---------------|----|-------------|---------------|

## Note 4 - Fair Value Measurements

The Company follows GAAP guidance regarding fair value measurements. The valuation technique used to fair value the financial instruments is the market approach which uses prices and other relevant information generated by market transactions involving identical or comparable assets.

This guidance establishes a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the assets or liabilities fall within different levels of the hierarchy, the classification is based on the lowest level input that is significant to the fair value measurement of the asset or liability. Classification of assets and liabilities within the hierarchy considers the markets in which the assets and liabilities are traded, including during period of market disruption, and the reliability and transparency of the assumptions used to determine fair value. The hierarchy requires the use of observable market data when available. The levels of the hierarchy and those investments included in each are as follows:

Level 1—Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities traded in active markets. Included are those investments traded on an active exchange, such as the NASDAQ Global Select Market, U.S. Treasury securities and obligations of U.S. government agencies, together with corporate debt securities that are generally investment grade.

Level 2—Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability and market-corroborated inputs.

Level 3—Inputs to the valuation methodology are unobservable for the asset or liability and are significant to the fair value measurement. Material assumptions and factors considered in pricing investment securities and other assets may include appraisals, projected cash flows, market clearing activity or liquidity circumstances in the security or similar securities that may have occurred since the prior pricing period.

The availability of observable inputs varies and is affected by a wide variety of factors. When the valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires significantly more judgment. The degree of judgment exercised by management in determining fair value is greatest for investments categorized as Level 3. For investments in this category, the Company considers prices and inputs that are current as of the measurement date. In periods of market dislocation, as characterized by current market conditions, the observability of prices and inputs may be reduced for many instruments. This condition could cause a security to be reclassified between levels.

The Company's investments are allocated among pricing input levels at September 30, 2012 and December 31, 2011 as follows:

| (\$ in thousands)   | Level 1 | September 30, 2012     |         | Total |
|---|---------|------------------------|---------|-------|
|   |         | Level 2<br>(unaudited) | Level 3 |       |
| Fixed-maturity investments available for sale                 |         |                        |         |       |
| Political subdivisions of States, Territories and Possessions | -       | 5,819                  | -       | 5,819 |

|  |           |           |      |           |
|--|-----------|-----------|------|-----------|
| Corporate and other<br>bonds industrial and<br>miscellaneous | 8,334     | 8,949     | -    | 17,283    |
| Total fixed maturities                                       | 8,334     | 14,768    | -    | 23,102    |
| Equity investments   | 5,231     | -         | -    | 5,231     |
| Total investments  | \$ 13,565 | \$ 14,768 | \$ - | \$ 28,333 |



| (\$ in thousands)   | December 31, 2011 |           |         | Total     |
|---|-------------------|-----------|---------|-----------|
|   | Level 1           | Level 2   | Level 3 |           |
| Fixed-maturity investments available for sale   |                   |           |         |           |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 550            | \$ -      | \$ -    | \$ 550    |
| Political subdivisions of States, Territories and Possessions                         | -                 | 6,171     | -       | 6,171     |
| Corporate and other bonds industrial and miscellaneous                                | 8,465             | 7,383     | -       | 15,848    |
| Total fixed maturities  | 9,015             | 13,554    | -       | 22,569    |
| Equity investments  | 4,065             | -         | -       | 4,065     |
| Total investments   | \$ 13,080         | \$ 13,554 | \$ -    | \$ 26,634 |

#### Note 5 - Fair Value of Financial Instruments

GAAP requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the balance sheet, for which it is practicable to estimate fair value. The Company uses the following methods and assumptions in estimating its fair value disclosures for financial instruments:

Equity and fixed income investments: Fair value disclosures for investments are included in "Note 3 - Investments."

Cash and cash equivalents: The carrying values of cash and cash equivalents approximate their fair values because of the short maturity of these instruments.

Premiums receivable, reinsurance receivables: The carrying values reported in the accompanying consolidated balance sheets for these financial instruments approximate their fair values due to the short term nature of the assets.

Notes receivable: The carrying amount of notes receivable related to the sale of businesses approximates fair value because of the recently negotiated interest rates based on term of the loan, risk and guaranty.

Real Estate: The fair value of the land and building included in property and equipment, which is used in the Company's operations, approximates the carrying value. The fair value was based on an appraisal prepared using the sales comparison approach.

Reinsurance balances payable: The carrying value reported in the consolidated balance sheets for these financial instruments approximates fair value.

Notes payable (including related parties): The Company estimates that the carrying amount of notes payable approximates fair value because of the recently negotiated interest rates based on term of the loan, risk and guaranty.

The estimated fair values of the Company's financial instruments are as follows:

|  | September 30, 2012 |            | December 31, 2011 |            |
|--|--------------------|------------|-------------------|------------|
|  | Carrying Value     | Fair Value | Carrying Value    | Fair Value |
|  | (unaudited)        |            |                   |            |
| Fixed-maturity investments held to maturity  | \$606,273          | \$792,101  | \$606,234         | \$777,953  |
| Cash and cash equivalents                    | 2,447,849          | 2,447,849  | 173,126           | 173,126    |
| Premiums receivable                          | 6,854,026          | 6,854,026  | 5,779,085         | 5,779,085  |
| Receivables - reinsurance contracts          | 2,668,123          | 2,668,123  | 1,734,535         | 1,734,535  |
| Reinsurance receivables                      | 28,047,484         | 28,047,484 | 23,880,814        | 23,880,814 |
| Notes receivable-sale of business            | 331,207            | 331,207    | 393,511           | 393,511    |
| Real estate, net of accumulated depreciation | 1,446,196          | 1,510,000  | 1,477,639         | 1,510,000  |
| Reinsurance balances payable                 | 3,164,848          | 3,164,848  | 2,761,828         | 2,761,828  |
| Notes payable (including related parties)    | 1,097,000          | 1,097,000  | 1,047,000         | 1,047,000  |

#### Note 6 - Notes Receivable-Sale of Businesses

##### Pennsylvania Stores

Effective June 30, 2009, the Company sold all of the outstanding stock of the subsidiary that operated the three remaining Pennsylvania stores included in the former network of retail brokerage outlets (the "Pennsylvania Stock"). The purchase price for the Pennsylvania Stock was approximately \$397,000 which is being paid for by the payment of a promissory note with interest at the rate of 8.63% per annum and is payable in equal monthly installments of \$5,015.

##### Franchise Business

Effective May 1, 2009, the Company sold all of the outstanding stock of the subsidiaries that operated the Company's former DCAP franchise business (collectively, the "Franchise Stock"). The purchase price for the Franchise Stock was \$200,000 which was paid by delivery of a promissory note in such principal amount (the "Franchise Note"). The Franchise Note was paid in full during the quarter ended June 30, 2012.

Notes receivable arising from the sale of businesses as of September 30, 2012 and December 31, 2011 consists of:

|                             | September 30, 2012 |                                      |                   | December 31, 2011 |                       |                   |
|-----------------------------|--------------------|--------------------------------------|-------------------|-------------------|-----------------------|-------------------|
|                             | Total<br>Note      | Current<br>Maturities<br>(unaudited) | Long-Term         | Total<br>Note     | Current<br>Maturities | Long-Term         |
| Sale of Pennsylvania stores | \$ 328,842         | \$ 33,094                            | \$ 295,748        | \$ 351,861        | \$ 31,028             | \$ 320,833        |
| Sale of Franchise business  | -                  | -                                    | -                 | 37,797            | 37,797                | -                 |
|                             | 328,842            | 33,094                               | 295,748           | 389,658           | 68,825                | 320,833           |
| Accrued interest            | 2,365              | 2,365                                | -                 | 3,853             | 3,853                 | -                 |
| <b>Total</b>                | <b>\$ 331,207</b>  | <b>\$ 35,459</b>                     | <b>\$ 295,748</b> | <b>\$ 393,511</b> | <b>\$ 72,678</b>      | <b>\$ 320,833</b> |

#### Note 7 – Property and Casualty Insurance Activity

##### Earned Premiums

Premiums written, ceded and earned are as follows:

|   | Direct       | Assumed  | Ceded          | Net          |
|---|--------------|----------|----------------|--------------|
| Nine months ended September 30, 2012 (unaudited)  |              |          |                |              |
| Premiums written                                  | \$36,439,884 | \$21,553 | \$(21,699,102) | \$14,762,335 |
| Change in unearned premiums                       | (4,017,217)  | (9,119)  | 2,682,809      | (1,343,527)  |
| Premiums earned                                   | \$32,422,667 | \$12,434 | \$(19,016,293) | \$13,418,808 |
| Nine months ended September 30, 2011 (unaudited)  |              |          |                |              |
| Premiums written                                  | \$30,502,800 | \$6,289  | \$(18,099,446) | \$12,409,643 |
| Change in unearned premiums                       | (3,823,593)  | 1,611    | 2,234,476      | (1,587,506)  |
| Premiums earned                                   | \$26,679,207 | \$7,900  | \$(15,864,970) | \$10,822,137 |
| Three months ended September 30, 2012 (unaudited) |              |          |                |              |
| Premiums written                                  | \$12,765,358 | \$18,354 | \$(7,218,500)  | \$5,565,212  |
| Change in unearned premiums                       | (1,363,818)  | (13,031) | 1,093,338      | (283,511)    |
| Premiums earned                                   | \$11,401,540 | \$5,323  | \$(6,125,162)  | \$5,281,701  |
| Three months ended September 30, 2011 (unaudited) |              |          |                |              |
| Premiums written                                  | \$10,382,641 | \$3,409  | \$(6,119,576)  | \$4,266,474  |
| Change in unearned premiums                       | (909,125)    | (41)     | 579,881        | (329,285)    |
| Premiums earned                                   | \$9,473,516  | \$3,368  | \$(5,539,695)  | \$3,937,189  |

Premium receipts in advance of the policy effective date are recorded as advance premiums. The balance of advance premiums was approximately \$497,000 and \$545,000 as of September 30, 2012 (unaudited) and December 31, 2011, respectively.



## Loss and Loss Adjustment Expenses

The following table provides a reconciliation of the beginning and ending balances for unpaid losses and loss adjustment expenses (“LAE”):

|                                  | Nine months ended<br>September 30, |               |
|----------------------------------|------------------------------------|---------------|
|                                  | 2012                               | 2011          |
|                                  | (unaudited)                        |               |
| Balance at beginning of period   | \$ 18,480,717                      | \$ 17,711,907 |
| Less reinsurance recoverables    | (10,001,060)                       | (10,431,415)  |
| Net balance, beginning of period | 8,479,657                          | 7,280,492     |
| Incurred related to:             |                                    |               |
| Current year                     | 6,554,087                          | 6,742,201     |
| Prior years                      | 824,334                            | 565,724       |
| Total incurred                   | 7,378,421                          | 7,307,925     |
| Paid related to:                 |                                    |               |
| Current year                     | 2,572,948                          | 2,414,171     |
| Prior years                      | 2,681,698                          | 2,608,709     |
| Total paid                       | 5,254,646                          | 5,022,880     |
| Net balance at end of period     | 10,603,432                         | 9,565,537     |
| Add reinsurance recoverables     | 11,679,713                         | 11,808,025    |
| Balance at end of period         | \$ 22,283,145                      | \$ 21,373,562 |

Incurred losses and LAE are net of reinsurance recoveries under reinsurance contracts of \$6,917,332 and \$7,035,191 for the nine months ended September 30, 2012 and 2011, respectively.

Prior year incurred loss and LAE development is based upon numerous estimates by line of business and accident year. The Company’s management continually monitors claims activity to assess the appropriateness of carried case and IBNR reserves, giving consideration to Company and industry trends (See Note 13 - Subsequent events).

## Loss and loss adjustment expense reserves

The reserving process for loss adjustment expense reserves provides for the Company’s best estimate at a particular point in time of the ultimate unpaid cost of all losses and loss adjustment expenses incurred, including settlement and administration of losses, and is based on facts and circumstances then known and including losses that have been incurred but not yet been reported. The process includes using actuarial methodologies to assist in establishing these estimates, judgments relative to estimates of future claims severity and frequency, the length of time before losses will develop to their ultimate level and the possible changes in the law and other external factors that are often beyond the Company’s control. The loss ratio projection method is used to estimate loss reserves. The process produces carried reserves set by management based upon the actuaries’ best estimate and is the result of numerous best estimates made by line of business, accident year, and loss and loss adjustment expense. The amount of loss and loss adjustment expense reserves for reported claims is based primarily upon a case-by-case evaluation of coverage, liability, injury severity, and any other information considered pertinent to estimating the exposure presented by the claim. The amounts of loss and loss adjustment expense reserves for unreported claims are determined using historical information by line of insurance as adjusted to current conditions. Since this process produces loss reserves set by

management based upon the actuaries' best estimate, there is no explicit or implicit provision for uncertainty in the carried loss reserves.

Due to the inherent uncertainty associated with the reserving process, the ultimate liability may differ, perhaps substantially, from the original estimate. Such estimates are regularly reviewed and updated and any resulting adjustments are included in the current year's results. Reserves are closely monitored and are recomputed periodically using the most recent information on reported claims and a variety of statistical techniques. Specifically, on at least a quarterly basis, the Company reviews, by line of business, existing reserves, new claims, changes to existing case reserves and paid losses with respect to the current and prior years.

#### Reinsurance

The Company's reinsurance treaties for both its Personal Lines business, which primarily consists of homeowners' policies, and Commercial Lines business, other than commercial auto, were renewed as of July 1, 2012. The treaties, which are renewed annually, provide for the following material terms as of July 1, 2012:

#### Personal Lines

Personal Lines business, which includes homeowners, dwelling fire and canine legal liability insurance, is reinsured under a 75% quota share treaty which provides coverage with respect to losses of up to \$1,000,000 per occurrence. An excess of loss contract provides 100% of coverage for the next \$1,900,000 of losses for a total coverage with respect to losses of up to \$2,900,000 per occurrence. See "Catastrophe Reinsurance" below.

Personal umbrella policies are reinsured under a 90% quota share treaty limiting the Company to a maximum of \$100,000 per occurrence for the first \$1,000,000 of coverage. The second \$1,000,000 of coverage is 100% reinsured.

#### Commercial Lines

General liability commercial policies written by the Company, except for commercial auto policies, are reinsured under a 40% quota share treaty, which provides coverage with respect to losses of up to \$500,000 per occurrence. Excess of loss contracts provide 100% of coverage for the next \$2,400,000 of losses for a total coverage with respect to losses of up to \$2,900,000 per occurrence.

#### Commercial Auto

Commercial auto policies are covered by an excess of loss reinsurance contract which provides \$1,750,000 of coverage in excess of \$250,000.

#### Catastrophe Reinsurance

The Company has catastrophe reinsurance coverage with regard to losses of up to \$73,000,000. The initial \$3,000,000 of losses in a catastrophe are subject to a 75% quota share treaty, such that the Company retains \$750,000 per catastrophe occurrence. With respect to any additional catastrophe losses of up to \$70,000,000, the Company is 100% reinsured under its catastrophe reinsurance program.

The Company's reinsurance program is structured to enable the Company to significantly grow its premium volume while maintaining regulatory capital and other financial ratios generally within or below the expected ranges used for regulatory oversight purposes. The reinsurance program also provides income as a result of ceding commissions earned pursuant to the quota share reinsurance contracts. The Company's participation in reinsurance arrangements does not relieve the Company from its obligations to policyholders.





## Ceding Commission Revenue

The Company earns ceding commissions under its quota share reinsurance agreements based on a sliding scale of commission rates and ultimate treaty year loss ratios on the policies reinsured under each of these agreements. The sliding scale includes minimum and maximum commission rates in relation to specified ultimate loss ratios. The commission rate and ceding commissions earned increases when the estimated ultimate loss ratio decreases and, conversely, the commission rate and ceding commissions earned decreases when the estimated ultimate loss ratio increases.

As of September 30, 2012 and 2011, the Company's estimated ultimate loss ratios attributable to these contracts are lower than the contractual ultimate loss ratios at which the minimum amount of ceding commissions can be earned. Accordingly, the Company has recorded ceding commissions earned that are greater than the minimum provisional commissions (see Note 13 - Subsequent Events).

Ceding commission revenue consists of the following:

|                                       | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |              |
|---------------------------------------|-------------------------------------|--------------|------------------------------------|--------------|
|                                       | 2012                                | 2011         | 2012                               | 2011         |
|                                       | (unaudited)                         |              | (unaudited)                        |              |
| Provisional ceding commissions earned | \$ 2,171,391                        | \$ 1,763,930 | \$ 6,231,106                       | \$ 5,048,609 |
| Contingent ceding commissions earned  | 540,040                             | 543,460      | 2,294,839                          | 2,299,223    |
|                                       | \$ 2,711,431                        | \$ 2,307,390 | \$ 8,525,945                       | \$ 7,347,832 |

Provisional ceding commissions are settled monthly. Balances due from reinsurers for contingent ceding commissions on quota share treaties are settled annually based on the loss ratio of each treaty year that ends on June 30. Ceding commissions due from reinsurers, which include contingent ceding commissions receivable, as of September 30, 2012 (unaudited) and December 31, 2011 were \$2,668,123 and \$1,734,535, respectively, and are included in "Receivables – reinsurance contracts" in the Consolidated Balance Sheets.

## Note 8 – Long-Term Debt

Long-term debt consists of:

|                | September 30, 2012 |                                     |                | December 31, 2011 |                         |                |
|----------------|--------------------|-------------------------------------|----------------|-------------------|-------------------------|----------------|
|                | Total Debt         | Less Current Maturities (unaudited) | Long-Term Debt | Total Debt        | Less Current Maturities | Long-Term Debt |
| Notes payable  | \$ 747,000         | \$ -                                | \$ 747,000     | \$ 747,000        | \$ -                    | \$ 747,000     |
| Line of credit | 350,000            | 350,000                             | -              | 300,000           | 300,000                 | -              |
|                | \$ 1,097,000       | \$ 350,000                          | \$ 747,000     | \$ 1,047,000      | \$ 300,000              | \$ 747,000     |

## Notes Payable

From June 2009 through March 2010, the Company borrowed \$1,450,000 (including \$785,000 from related parties as disclosed below) and issued promissory notes in such aggregate principal amount (the “2009/2010 Notes”). The 2009/2010 Notes provided for interest at the rate of 12.625% per annum through the maturity date of July 10, 2011. During the quarter the ended June 30, 2011, the Company prepaid \$703,000 (including \$407,000 to related parties) of the principal amount of the 2009/2010 Notes. In June 2011, the remaining note holders agreed to extend the maturity date for a period of three years from July 10, 2011 to July 10, 2014, and, effective July 11, 2011, reduce the interest rate from 12.625% to 9.5% per annum. The remaining 2009/2010 Notes, as extended, can be prepaid without premium or penalty. The reduction in the interest rate and the extension of the maturity date did not significantly change the fair value of the 2009/2010 Notes.

Interest expense on the 2009/2010 Notes for the nine months ended September 30, 2012 and 2011 was approximately \$53,000 and \$108,000, respectively. Interest expense includes related party borrowings for the nine months ended September 30, 2012 and 2011 of approximately \$27,000 and \$57,000, respectively. Interest expense on the 2009/2010 Notes for the three months ended September 30, 2012 and 2011 was approximately \$18,000 and \$24,000, respectively. Interest expense includes related party borrowings for the three months ended September 30, 2012 and 2011 of approximately \$9,000 and \$12,000, respectively.

Related party balances as of September 30, 2012 and December 31, 2011 under the 2009/2010 Notes are as follows:

|   |            |
|---|------------|
| Barry Goldstein IRA (Mr. Goldstein is Chairman of the Board, President and Chief Executive Officer, and principal stockholder of the Company) | \$ 90,000  |
| Jay Haft, a director of the Company   | 30,000     |
| A member of the family of Michael Feinsod, a director of the Company  | 60,000     |
| Sam Yedid, a director of KICO, and members of his family  | 156,000    |
| A member of the family of Floyd Tupper, a director of KICO  | 42,000     |
| Total related party balances  | \$ 378,000 |

## Line of credit

On December 27, 2011, Kingstone executed a Promissory Note pursuant to a line of credit (together, the “Trustco Agreement”) with Trustco Bank (“Lender”). Under the Trustco Agreement, Kingstone may receive advances from Lender not to exceed an unpaid principal balance of \$500,000. Advances extended under the Trustco Agreement will bear interest at a floating rate based on the Lender’s prime rate.

Interest only payments are due monthly. The principal balance is payable on demand, and must be reduced to zero for a minimum of thirty consecutive days during each year of the term of the Trustco Agreement. The principal balance was reduced to zero for thirty consecutive days in accordance with terms of the Trustco Agreement within the three month period ended September 30, 2012. Lender may set off any depository accounts maintained by Kingstone that are held by Lender. Payment of amounts due pursuant to the Trustco Agreement is secured by all of Kingstone’s cash and deposit accounts, receivables, inventory and fixed assets, and is guaranteed by Kingstone’s subsidiary, Payments, Inc.

There were no closing costs or fees paid in connection with the Trustco Agreement. Kingstone received an initial advance of \$300,000 on December 27, 2011. The line of credit is being used for general corporate purposes.

The interest rate on the amount outstanding as of September 30, 2012 was 3.75%. There are no other fees in connection with this credit line.



## Note 9 – Stockholders’ Equity

## Dividend Declared

Dividends declared and paid on Common Stock was \$380,046 and \$115,153 for the nine months ended September 30, 2012 and 2011, respectively. Dividends declared and paid on Common Stock was \$153,218 and \$115,153 for the three months ended September 30, 2012 and 2011, respectively. The Company’s Board of Directors approved a quarterly dividend on November 12, 2012 of \$.04 per share payable in cash on December 14, 2012 to stockholders of record as of November 30, 2012.

## Stock Options

In December 2005, the Company’s shareholders ratified the adoption of the 2005 Equity Participation Plan (the “2005 Plan”), which provides for the issuance of incentive stock options, non-statutory stock options and restricted stock. Under the 2005 Plan, a maximum of 300,000 shares of Common Stock were permitted to be issued pursuant to options granted and restricted stock issued. In March 2010, the Board of Directors of the Company increased the number of shares of Common Stock authorized to be issued pursuant to the 2005 Plan to 550,000, subject to stockholder approval. In June 2010, the stockholders approved the increase to 550,000 shares. Incentive stock options granted under the 2005 Plan expire no later than ten years from date of grant (except no later than five years for a grant to a 10% stockholder). The Board of Directors or the Stock Option Committee will determine the expiration date with respect to non-statutory options, and the vesting provisions for restricted stock, granted under the 2005 Plan.

The results of operations for the nine months ended September 30, 2012 and 2011 include share-based stock option compensation expense totaling \$39,000 and \$86,000, respectively. The results of operations for the three months ended September 30, 2012 and 2011 include share-based stock option compensation expense totaling \$9,000 and \$21,000, respectively. Share-based compensation expense related to stock options is net of estimated forfeitures of 21% for the nine months and three months ended September 30, 2012 and 2011, respectively. Such amounts have been included in the Condensed Consolidated Statements of Comprehensive Income within other operating expenses.

Stock option compensation expense in 2012 and 2011 is the estimated fair value of options granted amortized on a straight-line basis over the requisite service period for the entire portion of the award. No stock options were granted during the nine months ended September 30, 2012 and 2011.

A summary of option activity under the Company’s 1998 Stock Option Plan (terminated in November, 2008) and the 2005 Plan as of September 30, 2012, and changes during the nine months then ended, is as follows:

| Stock Options                  | Number of Shares | Weighted Average Exercise Price per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--------------------------------|------------------|---|---|---------------------------|
| Outstanding at January 1, 2012 | 393,865          | \$2.32                                    | 2.28  | \$498,913                 |
| Granted                        | -                | \$-                                       | -   | \$-                       |
| Exercised                      | (135,000 )       | \$2.13                                    | -   | \$319,925                 |
| Forfeited                      | -                | \$-                                       | -   | \$-                       |

|  |         |        |      |           |
|--|---------|--------|------|-----------|
| Outstanding at September 30, 2012            | 258,865 | \$2.43 | 2.10 | \$689,510 |
| Vested and Exercisable at September 30, 2012 | 199,148 | \$2.41 | 2.02 | \$533,043 |

21

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The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2012 is calculated as the difference between the exercise price of the underlying options and the market price of the Company's Common Stock for the options that had exercise prices that were lower than the \$5.09 closing price of the Company's Common Stock on September 30, 2012. The total intrinsic value of options exercised in the nine months ended September 30, 2012 was \$319,925, determined as of the date of exercise.

Participants in the 2005 Plan may exercise their outstanding vested options, in whole or in part, by having the Company reduce the number of shares otherwise issuable by a number of shares having a fair market value equal to the exercise price of the option being exercised ("Cashless Exercise"). The Company received cash proceeds of \$47,074 from 22,500 options exercised in the nine months ended September 30, 2012. The remaining 112,500 options exercised in 2012 were Cashless Exercises. No stock options were exercised in the nine months ended September 30, 2011.

As of September 30, 2012, the fair value of unamortized compensation cost related to unvested stock option awards was approximately \$16,000. Unamortized compensation cost as of September 30, 2012 is expected to be recognized over a remaining weighted-average vesting period of .58 years.

#### Note 10 – Income Taxes

The Company files a consolidated U.S. Federal Income Tax return that includes all wholly-owned subsidiaries. State tax returns are filed on a consolidated or separate basis depending on applicable laws. The Company records adjustments related to prior years' taxes during the period when they are identified, generally when the tax returns are filed. The effect of these adjustments on the current and prior periods (during which the differences originated) is evaluated based upon quantitative and qualitative factors and are considered in relation to the financial statements taken as a whole for the respective periods. The Company has evaluated this year's amounts in relation to the current and prior reporting periods and determined that a restatement of those prior reporting periods is not appropriate. The Company's effective tax rate from continuing operations for the nine months and three months ended September 30, 2012 was 33.0% and 30.6%, respectively. The Company's effective tax rate from continuing operations for the nine months and three months ended September 30, 2011 was 24.1% and (46.4)%, respectively. A reconciliation of the Federal statutory rate to our effective rate from continuing operations is as follows:

|                                     | For the Three Months Ended |        |          | For the Nine Months Ended |             |        |           |        |
|-------------------------------------|----------------------------|--------|----------|---------------------------|-------------|--------|-----------|--------|
|                                     | September 30,              |        |          | September 30,             |             |        |           |        |
|                                     | 2012                       |        | 2011     | 2012                      |             | 2011   |           |        |
| Computed expected tax expense       | \$447,491                  | 34.0 % | \$51,003 | 34.0 %                    | \$1,136,779 | 34.0 % | \$501,775 | 34.0 % |
| State taxes, net of Federal benefit | 9,754                      | 0.7    | (10,225) | (6.8)                     | 55,553      | 1.7    | (24,976)  | (1.7)  |
| Permanent differences               |                            |        |          |                           |             |        |           |        |
| Dividends received deduction        | (10,386)                   | (0.8)  | (18,782) | (12.5)                    | (46,963)    | (1.4)  | (25,911)  | (1.8)  |
| Non-taxable investment income       | (15,781)                   | (1.2)  | (16,449) | (11.0)                    | (49,590)    | (1.5)  | (62,992)  | (4.3)  |
| Stock-based compensation expense    | 3,065                      | 0.2    | 7,284    | 4.9                       | 13,302      | 0.4    | 29,094    | 2.0    |
|                                     | 6,287                      | 0.5    | (42,889) | (28.6)                    | 18,568      | 0.6    | (28,344)  | (1.9)  |

|                             |           |        |            |           |             |        |           |        |  |
|-----------------------------|-----------|--------|------------|-----------|-------------|--------|-----------|--------|--|
| Other permanent differences |           |        |            |           |             |        |           |        |  |
| Prior year tax matters      | (32,456 ) | (2.5 ) | (72,960)   | (48.6 )   | (32,456 )   | (1.0 ) | (50,886)  | (3.5 ) |  |
| Other                       | (5,812 )  | (0.4 ) | 33,458     | 22.3      | 8,554       | 0.3    | 17,926    | 1.2    |  |
| Total tax                   | \$402,162 | 30.6 % | \$(69,560) | (46.4 ) % | \$1,103,747 | 33.0 % | \$355,686 | 24.1 % |  |

Deferred tax assets and liabilities are determined using the enacted tax rates applicable to the period the temporary differences are expected to be recovered. Accordingly, the current period income tax provision can be affected by the enactment of new tax rates. The net deferred income taxes on the balance sheet reflect temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and income tax purposes, tax effected at a various rates depending on whether the temporary differences are subject to Federal taxes, State taxes, or both. Significant components of the Company's deferred tax assets and liabilities are as follows:

|  | September 30,<br>2012<br>(unaudited) | December 31,<br>2011 |
|--|--------------------------------------|----------------------|
| Deferred tax asset:  |                                      |                      |
| Net operating loss carryovers (1)                              | \$ 264,648                           | \$ 276,312           |
| Claims reserve discount  | 275,543                              | 220,354              |
| Unearned premium   | 735,723                              | 647,596              |
| Deferred ceding commission revenue                             | 1,585,172                            | 1,354,016            |
| Other  | 13,721                               | 4,583                |
| Total deferred tax assets                                      | 2,874,807                            | 2,502,861            |
| Deferred tax liability:  |                                      |                      |
| Investment in KICO (2)   | 1,169,000                            | 1,169,000            |
| Deferred acquisition costs                                     | 1,835,200                            | 1,542,163            |
| Intangibles  | 1,123,321                            | 1,244,628            |
| Depreciation and amortization                                  | 136,117                              | 133,411              |
| Reinsurance recoverable  | 20,400                               | 20,400               |
| Net unrealized appreciation of securities - available for sale | 601,891                              | 172,155              |
| Investment income  | -                                    | 10,543               |
| Total deferred tax liabilities                                 | 4,885,929                            | 4,292,300            |
| Net deferred income tax liability                              | \$ (2,011,122)                       | \$ (1,789,439)       |

(1) The deferred tax assets from net operating loss carryovers are as follows:

| Type of NOL   | September 30,<br>2012 | December 31,<br>2011 | Expiration<br>December |
|---|-----------------------|----------------------|------------------------|
| State only (A)  | \$ 364,633            | \$ 284,749           | 31, 2027               |
| Valuation allowance   | 130,585               | 42,437               |                        |
| State only, net of valuation allowance                      | 234,048               | 242,312              |                        |
| Amount subject to Annual Limitation, Federal only (B)       | 30,600                | 34,000               | December<br>31, 2019   |
| Total deferred tax asset from net operating loss carryovers | \$ 264,648            | \$ 276,312           |                        |

(A) Kingstone generates operating losses for state purposes and has prior year net operating loss carryovers available. KICO, the Company's insurance underwriting subsidiary, is not subject to state income taxes. KICO's state tax obligations are paid through a gross premiums tax which is included in the Condensed Consolidated Statements of Comprehensive Income within other underwriting expenses. A valuation allowance has been recorded due to the uncertainty of generating enough state taxable income to utilize 100% of the available state net operating loss carryovers over their remaining lives which expire between 2022 and 2027.



(B) NOL is subject to Internal Revenue Code Section 382, which places a limitation on the utilization of the federal net operating loss to approximately \$10,000 per year (“Annual Limitation”) as a result of a greater than 50% ownership change of the Company in 1999. The losses subject to the Annual Limitation will be available for future years, expiring through December 31, 2019.

(2) Deferred tax liability - investment in KICO

On July 1, 2009, the Company completed the acquisition of 100% of the issued and outstanding common stock of KICO (formerly known as Commercial Mutual Insurance Company (“CMIC”)) pursuant to the conversion of CMIC from an advance premium cooperative to a stock property and casualty insurance company. Pursuant to the plan of conversion, the Company acquired a 100% equity interest in KICO, in consideration for the exchange of \$3,750,000 principal amount of surplus notes of CMIC. In addition, the Company forgave all accrued and unpaid interest on the surplus notes as of the date of conversion. As of the date of acquisition, unpaid accrued interest on the surplus notes along with the accretion of the discount on the original purchase of the surplus notes totaled \$2,921,319 (together “Untaxed Interest”). As of the date of acquisition the deferred tax liability on the Untaxed Interest was \$1,169,000. Under GAAP guidance for business combinations, a temporary difference with an indefinite life exists when the parent has a lower carrying value of its subsidiary for income tax purposes. The Company is required to maintain its deferred tax liability of \$1,169,000 related to this temporary difference until either the stock of KICO is sold, the assets of KICO are sold or KICO and the parent are merged.

The Company had no material unrecognized tax benefit and no adjustments to liabilities or operations were required. There were no interest or penalties related to income taxes that have been accrued or recognized as of and for nine months ended September 30, 2012 and 2011. If any had been recognized these would be reported in income tax expense.

IRS Tax Audit

The Company’s Federal income tax return for the year ended December 31, 2009 has been examined by the Internal Revenue Service and was accepted as filed. The tax returns for years ended December 31, 2010 and 2011 are subject to examination, generally for three years after filing.

Note 11 - Net Income Per Common Share

Basic net earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding. Diluted earnings per share reflect, in periods in which they have a dilutive effect, the impact of common shares issuable upon exercise of vested stock options. The computation of diluted earnings per share excludes those options with an exercise price in excess of the average market price of the Company’s common shares during the periods presented.

For the nine months and three months ended September 30, 2012 there were 199,148 vested options with an exercise price below the average market price of the Company’s Common Stock during the period. For the nine months and three months ended September 30, 2011 there were 269,432 vested options with an exercise price below the average market price of the Company’s Common Stock during the period.

The reconciliation of the weighted average number of shares of Common Stock and net income used in the calculation of basic and diluted earnings per common share follows:

|  | Three months ended<br>September 30,<br>2012      2011<br>(unaudited) |           | Nine months ended<br>September 30,<br>2012      2011<br>(unaudited) |             |
|--|--|-----------|---|-------------|
| Net income used in the calculation of basic earnings per share                               | \$913,987  | \$219,569 | \$2,239,721   | \$1,120,124 |
| Effect of dilutive securities, common share equivalents                                      | 455  | 1,117     | 39,434  | -           |
| Net income used for computing diluted earnings per share                                     | \$914,442  | \$220,686 | \$2,279,155   | \$1,120,124 |
| Weighted average number of shares outstanding  | 3,824,461  | 3,838,386 | 3,794,979   | 3,838,386   |
| Effect of dilutive securities, common share equivalents                                      | 111,706  | 74,650    | 89,193  | -           |
| Weighted average number of shares outstanding, used for computing diluted earnings per share | 3,936,167  | 3,913,036 | 3,884,172   | 3,838,386   |

#### Note 12 - Commitments and Contingencies

##### Legal Proceedings

From time to time, the Company is involved in various legal proceedings in the ordinary course of business. For example, to the extent a claim asserted by a third party in a law suit against one of the Company's insureds covered by a particular policy, the Company may have a duty to defend the insured party against the claim. These claims may relate to bodily injury, property damage or other compensable injuries as set forth in the policy. Such proceedings are considered in estimating the liability for loss and LAE expenses. The Company is not subject to any other pending legal proceedings that management believes are likely to have a material adverse effect on the financial statements.

##### Employment Agreement

Effective January 1, 2012, Barry Goldstein, the Company's President, Chairman of the Board and Chief Executive Officer, assumed the positions of President and Chief Executive Officer of KICO. Effective April 16, 2012, the Company entered into an amendment to its employment agreement with Mr. Goldstein, pursuant to which, effective January 1, 2012 and continuing through the term of the agreement, Mr. Goldstein's annual base salary was increased to \$450,000 from \$375,000 in consideration for his additional responsibilities to KICO.

Note 13 – Subsequent Event

Dividends Declared and Paid

On November 12, 2012, the Company's board of directors approved a dividend of \$.04 per share payable in cash on December 14, 2012 to stockholders of record as of November 30, 2012.

Superstorm Sandy

The New York City area, the primary location of KICO's insureds, was struck by Superstorm Sandy on October 29, 2012. KICO purchases quota share and catastrophe reinsurance in order to reduce its net liability on insurance risks and to protect against catastrophes. KICO's personal lines business, which includes homeowners insurance, is reinsured under a 75% quota share treaty and catastrophe insurance pursuant to which KICO's net liability is limited to 25% of the initial \$3,000,000 of direct losses incurred from an occurrence, or \$750,000. For catastrophe losses in excess of \$3,000,000, KICO is 100% covered by catastrophe reinsurance with regard to the next \$70,000,000 in losses. The Company estimates that its net losses incurred as a result of the storm will be \$750,000 with respect to KICO's personal lines business, which is the limit of loss pursuant to its quota share and catastrophe reinsurance treaties. Additional losses will be incurred with respect to KICO's commercial auto and livery physical damage policies.

KICO receives ceding commissions from the reinsurers. The amount of the commissions includes contingent ceding commissions which are based upon the loss ratio experienced by the reinsurers during the treaty term (July 1 to June 30) from the ceded business over that period of time. During the three month period ended September 30, 2012 (which was the initial quarter of the 2012-2013 treaty year), the Company's revenue includes contingent ceding commission revenue of \$755,000. Such contingent ceding commission revenue is subject to downward adjustment (to possibly less than zero) based upon the reinsurance losses expected to be incurred as a result of Superstorm Sandy. In addition, it is expected that there will be a significant decline in the ceding commission revenue earned during the 4th quarter of 2012 and the first two quarters of 2013 (i.e., the final nine months of the 2012-2013 treaty); however, the amount cannot yet be reasonably estimated due to the high volume of claims that KICO has already received and the anticipation of many more to follow. Further, KICO will be required to pay reinstatement premiums to catastrophe reinsurers to obtain coverage for future catastrophe events during the current reinsurance treaty period. Accordingly, the effects of the storm will be material to the Company's post-3rd quarter of 2012 results of operations; however, the Company expects that, based upon its results of operations for the three and nine months ended September 30, 2012, such effects will not have a material adverse impact on its financial condition.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

### Overview

We offer property and casualty insurance products to small businesses and individuals in New York State through our subsidiary, Kingstone Insurance Company ("KICO"). KICO's insureds are located primarily in downstate New York, consisting of New York City, Long Island and Westchester County.

We derive 99% of our revenue from KICO, which includes revenues from earned premiums, ceding commissions from quota share reinsurance, net investment income generated from our portfolio, and net realized gains and losses on investment securities. All of our policies are for a one year period. Earned premiums represent premiums received from insureds, which are recognized as revenue over the period of time that insurance coverage is provided (i.e., ratably over the one year life of the policy). A significant period of time normally elapses between the receipt of insurance premiums and the payment of insurance claims. During this time, KICO invests the premiums, earns investment income and generates net realized and unrealized investment gains and losses on investments.

Our expenses include the insurance underwriting expenses of KICO and other operating expenses. Insurance companies incur a significant amount of their total expenses from policyholder losses, which are commonly referred to as claims. In settling policyholder losses, various loss adjustment expenses ("LAE") are incurred such as insurance adjusters' fees and litigation expenses. In addition, insurance companies incur policy acquisition expenses. Policy acquisition costs include commissions paid to producers, premium taxes, and other expenses related to the underwriting process, including employees' compensation and benefits.

Other operating expenses include the corporate expenses of our holding company, Kingstone Companies, Inc. These expenses include legal and auditing fees, occupancy costs related to our corporate office, executive employment costs, and other costs directly associated with being a public company.

We utilize the following key measures in analyzing the results of our insurance underwriting business:

**Net loss ratio.** The net loss ratio is a measure of the underwriting profitability of an insurance company's business. Expressed as a percentage, this is the ratio of net losses and loss adjustment expenses ("LAE") incurred to net premiums earned.

**Net underwriting expense ratio.** The net underwriting expense ratio is a measure of an insurance company's operational efficiency in administering its business. Expressed as a percentage, this is the ratio of the sum of acquisition costs (the most significant being commissions paid to our producers) and other underwriting expenses less ceding commission revenue less other income to net premiums earned.

**Net combined ratio.** The net combined ratio is a measure of an insurance company's overall underwriting profit. This is the sum of the net loss and net underwriting expense ratios. If the net combined ratio is at or above 100 percent, an insurance company cannot be profitable without investment income, and may not be profitable if investment income is insufficient.

**Underwriting income.** Underwriting income is net pre-tax income attributable to our insurance underwriting business except for net investment income, net realized gains from investments, and depreciation and amortization (net premiums earned less expenses included in combined ratio). Underwriting income is a measure of an insurance company's overall operating profitability before items such as investment income, depreciation and amortization, interest expense and income taxes.



### Critical Accounting Policies

Our condensed consolidated financial statements include the accounts of Kingstone Companies, Inc. and all majority-owned and controlled subsidiaries. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires our management to make estimates and assumptions in certain circumstances that affect amounts reported in our consolidated financial statements and related notes. In preparing these financial statements, our management has utilized information available including our past history, industry standards and the current economic environment, among other factors, in forming its estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. It is possible that the ultimate outcome as anticipated by our management in formulating its estimates inherent in these financial statements might not materialize. However, application of the critical accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. In addition, other companies may utilize different estimates, which may impact comparability of our results of operations to those of companies in similar businesses.

We believe that the most critical accounting policies relate to the reporting of reserves for loss and LAE, including losses that have occurred but have not been reported prior to the reporting date, amounts recoverable from third party reinsurers, deferred ceding commission revenue, deferred policy acquisition costs, deferred income taxes, the impairment of investment securities, intangible assets and the valuation of stock based compensation. See Note 2 to the Condensed Consolidated Financial Statements - "Accounting Policies and Basis of Presentation" for information related to updated accounting policies.

## Consolidated Results of Operations

Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011

The following table summarizes the changes in the results of our operations (in thousands) for the periods indicated:

| (\$ in thousands)  | Nine months ended September 30, |                 |                 |                |
|--|---------------------------------|-----------------|-----------------|----------------|
|  | 2012                            | 2011            | Change          | Percent        |
| <b>Revenues</b>  |                                 |                 |                 |                |
| Direct and assumed written premiums                        | \$ 36,461                       | \$ 30,509       | \$ 5,952        | 19.5 %         |
| Net written premiums                                       | 14,762                          | 12,410          | 2,352           | 19.0 %         |
| Change in net unearned premiums                            | (1,344 )                        | (1,588 )        | 244             | (15.4 )%       |
| Net premiums earned  | 13,418                          | 10,822          | 2,596           | 24.0 %         |
| Ceding commission revenue (1)                              | 8,526                           | 7,348           | 1,178           | 16.0 %         |
| Net investment income                                      | 740                             | 510             | 230             | 45.1 %         |
| Net realized gain on investments                           | 112                             | 357             | (245 )          | (68.6 )%       |
| Other income   | 680                             | 693             | (13 )           | (1.9 )%        |
| <b>Total revenues</b>                                      | <b>23,476</b>                   | <b>19,730</b>   | <b>3,746</b>    | <b>19.0 %</b>  |
| <b>Expenses</b>  |                                 |                 |                 |                |
| <b>Loss and loss adjustment expenses (1)</b>               |                                 |                 |                 |                |
| Direct loss and loss adjustment expenses                   | 14,295                          | 14,343          | (48 )           | (0.3 %)        |
| Less: ceded loss and loss adjustment expenses              | (6,917 )                        | (7,035 )        | 118             | (1.7 )%        |
| Net loss and loss adjustment expenses                      | 7,378                           | 7,308           | 70              | 1.0 %          |
| Commission expense   | 5,430                           | 4,473           | 957             | 21.4 %         |
| Other underwriting expenses                                | 5,986                           | 5,045           | 941             | 18.7 %         |
| Other operating expenses                                   | 830                             | 863             | (33 )           | (3.8 )%        |
| Depreciation and amortization                              | 447                             | 457             | (10 )           | (2.2 )%        |
| Interest expense   | 61                              | 108             | (47 )           | (43.5 )%       |
| <b>Total expenses</b>                                      | <b>20,132</b>                   | <b>18,254</b>   | <b>1,878</b>    | <b>10.3 %</b>  |
| Income from operations before taxes                        | 3,344                           | 1,476           | 1,868           | 126.6 %        |
| Provision for income tax                                   | 1,104                           | 356             | 748             | 210.1 %        |
| <b>Net income</b>  | <b>\$ 2,240</b>                 | <b>\$ 1,120</b> | <b>\$ 1,120</b> | <b>100.0 %</b> |
| <b>Percent of total revenues:</b>                          |                                 |                 |                 |                |
| Net premiums earned  | 57.2 %                          | 54.9 %          |                 |                |
| Ceding commission revenue                                  | 36.3 %                          | 37.2 %          |                 |                |
| Net investment income                                      | 3.2 %                           | 2.6 %           |                 |                |
| Net realized gains on investments                          | 0.5 %                           | 1.8 %           |                 |                |
| Other income   | 2.9 %                           | 3.5 %           |                 |                |
|  | 100.0 %                         | 100.0 %         |                 |                |
| <b>Net loss ratio excluding the effect of catastrophes</b> |                                 |                 |                 |                |
| Net catastrophe loss                                       | 0.0 %                           | 3.9 %           |                 |                |
| <b>Net loss ratio</b>                                      | <b>55.0 %</b>                   | <b>67.5 %</b>   |                 |                |



(1) Includes net catastrophe losses and net loss adjustment expenses for the nine months ended September 30, 2011 of \$422,000 incurred from August 27, 2011 to August 29, 2011 from Tropical Storm Irene. During the quarter that a catastrophe occurs, it is not possible to estimate the full amount of losses and loss adjustment expenses incurred. Accordingly, additional net catastrophe losses and net loss adjustment expenses from Tropical Storm Irene were recorded subsequent to September 30, 2011. Catastrophe losses incurred from Tropical Storm Irene decreased our ceded loss ratio which reduced our contingent ceding commission revenue by \$493,000. For the nine months ended September 30, 2012, we did not incur any catastrophe losses and loss adjustment expenses. We define a “catastrophe” as an event that involves multiple first party policyholders, or an event that produces a number of claims in excess of a preset, per-event threshold of average claims in a specific area, occurring within a certain amount of time constituting the event. Catastrophes are caused by various natural events including high winds, excessive rain, winter storms, tornadoes, hailstorms, wildfires, tropical storms, and hurricanes. See Note 13 to the Consolidated Financial Statements – “Subsequent Events” for information relating to the effects of Superstorm Sandy that occurred in October 2012.

Direct and assumed written premiums during the nine months ended September 30, 2012 (“2012”) were \$36,461,000 compared to \$30,509,000 during the nine months ended September 30, 2011 (“2011”). The increase of \$5,952,000, or 19.5%, was primarily due to an increase in policies in-force during 2012 as compared to 2011. We wrote more policies as a result of an increase in demand for the products in the markets that we serve. Policies in-force increased by 18.9% as of September 30, 2012 compared to September 30, 2011. In addition to the increase of policies in-force, we are also writing more policies which have higher premiums.

Net written premiums increased \$2,352,000, or 19.0%, to \$14,762,000 in 2012 from \$12,410,000 in 2011. The increase in net written premiums resulted from: (1) an increase in direct written premiums in 2012 compared to direct written premiums in 2011, and (2) effective July 1, 2012, a decrease in quota share percentage in our commercial lines from 60% to 40%. A decrease in the quota share percentage results in us retaining a greater amount of direct written premiums. Net written premiums grew at a lower rate than direct written premiums (19.0% compared to 19.5%) due to increases in policies written in lines of business that are subject to quota share reinsurance treaties, primarily personal lines and commercial lines, in excess of the decrease in policies written in lines of business without quota share reinsurance treaties, primarily commercial auto lines.

Net premiums earned increased \$2,596,000, or 24.0%, to \$13,418,000 in 2012 from \$10,822,000 in 2011. As premiums written earn ratably over a twelve month period, the increase was a result of higher net written premiums for the twelve months ended September 30, 2012 compared to the twelve months ended September 30, 2011.

The following table summarizes the changes in the components of ceding commission revenue (in thousands) for the periods indicated:

| (\$ in thousands)                     | Nine months ended September 30, |          |          |         |
|---------------------------------------|---------------------------------|----------|----------|---------|
|                                       | 2012                            | 2011     | Change   | Percent |
| Provisional ceding commissions earned | \$ 6,231                        | \$ 5,049 | \$ 1,182 | 23.4 %  |
| Contingent ceding commissions earned  | 2,295                           | 2,299    | (4 )     | (0.2 )% |
| Total ceding commission revenue       | \$ 8,526                        | \$ 7,348 | \$ 1,178 | 16.0 %  |

Ceding commission revenue was \$8,526,000 in 2012 compared to \$7,348,000 in 2011. The increase of \$1,178,000, or 16.0%, was due a \$1,182,000 increase in provisional ceding commissions earned offset by a \$4,000 decrease in contingent ceding commissions earned. The \$1,182,000 increase in provisional ceding commissions earned is due to a net increase in the amount of premiums ceded.

Net investment income was \$740,000 in 2012 compared to \$510,000 in 2011. The increase of \$230,000, or 45.1%, was due to an increase in average invested assets in 2012 as compared to 2011. The increase in cash and invested assets resulted primarily from increased operating cash flows and by an adjustment to amortization of bond premium in 2011. The tax equivalent investment yield, excluding cash, was 4.99% and 5.07% at September 30, 2012 and 2011, respectively.

Net realized gains on investments were \$112,000 in 2012 compared to \$357,000 in 2011. The decrease of \$245,000, or 68.6%, was due to an FDIC recovery of \$133,000 in 2011 from a failed bank which was included in other than temporary impaired losses in 2009.

Net loss and loss adjustment expenses were \$7,378,000 in 2012 compared to \$7,308,000 in 2011. The net loss ratio was 55.0% in 2012 compared to 67.5% in 2011. The decrease of 12.5 percentage points in our net loss ratio for 2012 as compared to 2011 is primarily due to a decrease in the loss ratios in our personal lines and commercial lines of

business. As a result of Tropical Storm Irene in 2011, which we define as a catastrophe, we incurred \$422,000 of losses and loss adjustment expenses (net of reinsurance recoverable of \$1,266,000), and added 3.9 percentage points to our 2011 net loss ratio.

Commission expense was \$5,430,000 in 2012 or 14.9% of direct written premiums. Commission expense was \$4,473,000 in 2011 or 14.7% of direct written premiums. The increase of \$957,000 is due to the increase in direct written premiums in 2012 as compared to 2011.

Other underwriting expenses were \$5,986,000 in 2012 compared to \$5,045,000 in 2011. The \$941,000, or 18.7%, increase in other underwriting expenses was primarily due to expenses directly related to the increase in direct written premiums, increase in occupancy costs and additional employment costs due to both the hiring of additional staff needed to service our growth in written premiums and increases in annual salaries. Underwriting expenses as a percentage of direct written premiums was 16.4% in 2012 and 16.5% in 2011. Our other underwriting expenses increased at a lower rate than the growth in our direct written premiums.

Other operating expenses, related to the corporate expenses of our holding company, were \$830,000 in 2012 compared to \$863,000 in 2011. The \$33,000 decrease in 2012 was primarily due to a decrease in occupancy costs and amortization of stock options as a result of more stock options being fully vested prior to September 30, 2012, offset by increase in professional fees.

Interest expense was \$61,000 in 2012 compared to \$108,000 in 2011. The \$47,000 decrease in interest expense was due to the partial redemption of \$703,000 to our 2009/2010 Notes during the quarter ended September 30, 2011, and effective July 11, 2011, a reduction in the interest rate to 9.5% per annum from the previous 12.625% per annum.

Income tax expense in 2012 was \$1,104,000, which resulted in an effective tax rate of 33.0%. Income tax expense in 2011 was \$356,000, which resulted in an effective tax rate of 24.1%. Income before taxes was \$3,344,000 in 2012 compared to \$1,476,000 in 2011. The increase in the effective tax rate by 8.9% in 2012 is a result of: (A) permanent differences from non taxable investment income and the dividends received deduction having a lesser impact on the effective tax rate in 2012 due to a greater amount of book income in 2012 compared to 2011, and (B) recording a valuation allowance in 2012 against our state net operating loss carryovers compared to no such allowance in 2011. Kingstone Companies, Inc. generates operating losses for state purposes and has prior year net operating loss carryovers available. KICO, our insurance underwriting subsidiary, is not subject to state income taxes. A valuation allowance of \$42,000 was recorded by us in December 2011 and an additional valuation allowance of \$88,000 was recorded in 2012. The valuation allowance was established due to the uncertainty of generating enough state taxable income to utilize 100% of our available state net operating loss carryovers over their remaining lives which expire between 2022 and 2027.

Net income was \$2,240,000 in 2012 compared to \$1,120,000 in 2011. The increase in net income of \$1,120,000 was due to the circumstances described above that caused the increases in our net premiums earned and ceding commission revenue, and a decrease in our net loss ratio, offset by increases in our other commission expense and underwriting expenses related to premium growth.

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

The following table summarizes the changes in the results of our operations (in thousands) for the periods indicated:

| (\$ in thousands)  | Three months ended September 30, |               |               |                |
|--|----------------------------------|---------------|---------------|----------------|
|  | 2012                             | 2011          | Change        | Percent        |
| <b>Revenues</b>  |                                  |               |               |                |
| Direct and assumed written premiums                        | \$ 12,783                        | \$ 10,386     | \$ 2,397      | 23.1 %         |
| Net written premiums                                       | 5,565                            | 4,267         | 1,298         | 30.4 %         |
| Change in net unearned premiums                            | (283 )                           | (330 )        | 47            | (14.2 )%       |
| Net premiums earned  | 5,282                            | 3,937         | 1,345         | 34.2 %         |
| Ceding commission revenue (1)                              | 2,711                            | 2,307         | 404           | 17.5 %         |
| Net investment income                                      | 242                              | 172           | 70            | 40.7 %         |
| Net realized gain on investments                           | 66                               | 197           | (131 )        | (66.5 )%       |
| Other income   | 219                              | 229           | (10 )         | (3.9 )%        |
| <b>Total revenues</b>                                      | <b>8,520</b>                     | <b>6,842</b>  | <b>1,678</b>  | <b>24.5 %</b>  |
| <b>Expenses</b>  |                                  |               |               |                |
| Loss and loss adjustment expenses (1)                      |                                  |               |               |                |
| Direct and assumed loss and loss adjustment expenses       | 4,981                            | 6,555         | (1,574 )      | (24.0 )%       |
| Less: ceded loss and loss adjustment expenses              | (2,290 )                         | (3,621 )      | 1,331         | (36.8 )%       |
| Net loss and loss adjustment expenses                      | 2,691                            | 2,934         | (243 )        | (8.3 )%        |
| Commission expense   | 1,953                            | 1,596         | 357           | 22.4 %         |
| Other underwriting expenses                                | 2,134                            | 1,734         | 400           | 23.1 %         |
| Other operating expenses                                   | 256                              | 260           | (4 )          | (1.5 )%        |
| Depreciation and amortization                              | 150                              | 144           | 6             | 4.2 %          |
| Interest expense   | 20                               | 24            | (4 )          | (16.7 )%       |
| <b>Total expenses</b>                                      | <b>7,204</b>                     | <b>6,692</b>  | <b>512</b>    | <b>7.7 %</b>   |
| Income from operations before taxes                        | 1,316                            | 150           | 1,166         | 777.3 %        |
| Provision for (benefit from) income tax                    | 402                              | (70 )         | 472           | (674.3 )%      |
| <b>Net income</b>  | <b>\$ 914</b>                    | <b>\$ 220</b> | <b>\$ 694</b> | <b>315.5 %</b> |
| <b>Percent of total revenues:</b>                          |                                  |               |               |                |
| Net premiums earned  | 62.0 %                           | 57.5 %        |               |                |
| Ceding commission revenue                                  | 31.8 %                           | 33.7 %        |               |                |
| Net investment income                                      | 2.8 %                            | 2.5 %         |               |                |
| Net realized gains on investments                          | 0.8 %                            | 2.9 %         |               |                |
| Other income   | 2.6 %                            | 3.3 %         |               |                |
|  | 100.0 %                          | 100.0 %       |               |                |
| <b>Net loss ratio excluding the effect of catastrophes</b> |                                  |               |               |                |
| Net catastrophe loss                                       | 0.0 %                            | 10.7 %        |               |                |
| <b>Net loss ratio</b>                                      | <b>51.0 %</b>                    | <b>74.5 %</b> |               |                |

(1) Includes net catastrophe losses and net loss adjustment expenses for the three months ended September 30, 2011 of \$422,000 incurred from August 27, 2011 to August 29, 2011 from Tropical Storm Irene. During the quarter that a catastrophe occurs, it is not possible to estimate the full amount of losses and loss adjustment expenses incurred. Accordingly, additional net catastrophe losses and net loss adjustment expenses from Tropical Storm Irene were recorded subsequent to September 30, 2011. Catastrophe losses incurred from Tropical Storm Irene decreased our ceded loss ratio which reduced our contingent ceding commission revenue by \$493,000. For the three months ended September 30, 2012, we did not incur any catastrophe losses and loss adjustment expenses. We define a “catastrophe” as an event that involves multiple first party policyholders, or an event that produces a number of claims in excess of a preset, per-event threshold of average claims in a specific area, occurring within a certain amount of time constituting the event. Catastrophes are caused by various natural events including high winds, excessive rain, winter storms, tornadoes, hailstorms, wildfires, tropical storms, and hurricanes. See Note 13 to the Consolidated Financial Statements – “Subsequent Events” for information relating to the effects of Superstorm Sandy that occurred in October 2012.

Direct and assumed written premiums during the three months ended September 30, 2012 (“Q3 2012”) were \$12,783,000 compared to \$10,386,000 during the three months ended September 30, 2011 (“Q3 2011”). The increase of \$2,397,000, or 23.1%, was primarily due to an increase in policies in-force during Q3 2012 as compared to Q3 2011. We wrote more policies as a result of an increase in demand for the products in the markets that we serve. Policies in-force increased by 18.9% as of September 30, 2012 compared to September 30, 2011. In addition to the increase of policies in-force, we are also writing more policies which have higher premiums.

Net written premiums increased \$1,298,000, or 30.4%, to \$5,565,000 in Q3 2012 from \$4,267,000 in 2011. The increase in net written premiums resulted from: (1) an increase in direct written premiums in Q3 2012 compared to direct written premiums in Q3 2011, and (2) effective July 1, 2012, a decrease in quota share percentage in our commercial lines from 60% to 40%. A decrease in the quota share percentage results in us retaining a greater amount of direct written premiums. Net written premiums grew at a greater rate than direct written premiums (30.4% compared to 23.1%) due to an increase in retained premiums as result of the change in quota share percentage in our commercial lines from 60% to 40% on July 1, 2012.

Net premiums earned increased \$1,345,000, or 34.2%, to \$5,282,000 in Q3 2012 from \$3,937,000 in Q3 2011. As premiums written earn ratably over a twelve month period, the increase was a result of higher net written premiums for the twelve months ended September 30, 2012 compared to the twelve months ended September 30, 2011.

The following table summarizes the changes in the components of ceding commission revenue (in thousands) for the periods indicated:

| (\$ in thousands)                     | Three months ended September 30, |          |        |         |
|---------------------------------------|----------------------------------|----------|--------|---------|
|                                       | 2012                             | 2011     | Change | Percent |
| Provisional ceding commissions earned | \$ 2,171                         | \$ 1,764 | \$ 407 | 23.1 %  |
| Contingent ceding commissions earned  | 540                              | 543      | (3 )   | (0.7 )% |
| Total ceding commission revenue       | \$ 2,711                         | \$ 2,307 | \$ 404 | 17.5 %  |

Ceding commission revenue was \$2,711,000 in Q3 2012 compared to \$2,307,000 in Q3 2011. The increase of \$403,000, or 17.5%, was due to a \$407,000 increase in provisional ceding commissions earned offset by a \$3,000 decrease in contingent ceding commissions earned. The \$407,000 increase in provisional ceding commissions earned is due to a net increase in the amount of premiums ceded.

Net investment income was \$242,000 in Q3 2012 compared to \$172,000 in Q3 2011. The increase of \$70,000, or 40.7%, was due to an increase in average invested assets in Q3 2012 as compared to Q3 2011. The increase in cash and invested assets resulted primarily from increased operating cash flows.. The tax equivalent investment yield, excluding cash, was 4.99% and 5.07% at September 30, 2012 and 2011, respectively.

Net realized gains on investments were \$66,000 in Q3 2012 compared to \$197,000 in Q3 2011. The decrease of \$131,000, or 66.5%, was due to an FDIC recovery of \$133,000 in Q3 2011 from a failed bank which was included in other than temporary impaired losses in 2009.

Net loss and loss adjustment expenses were \$2,691,000 in Q3 2012 compared to \$2,934,000 in 2011. The net loss ratio was 51.0% in Q3 2012 compared to 74.5% in Q3 2011. The decrease of 23.5 percentage points in our net loss ratio for Q3 2012 as compared to Q3 2011 is primarily due to a decrease in the loss ratios in our personal lines and commercial lines of business. As a result of Tropical Storm Irene in 2011, which we define as a catastrophe, we incurred \$422,000 of losses and loss adjustment expenses (net of reinsurance recoverable of \$1,266,000), and added

10.7 percentage points to our Q3 2011 net loss ratio.

Commission expense was \$1,953,000 in Q3 2012 or 15.3% of direct written premiums. Commission expense was \$1,596,000 in Q3 2011 or 15.4% of direct written premiums. The increase of \$357,000 is due to the increase in direct written premiums in Q3 2012 as compared to Q3 2011.

33

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Other underwriting expenses were \$2,134,000 in Q3 2012 compared to \$1,734,000 in Q3 2011. The \$400,000, or 23.1%, increase in other underwriting expenses was primarily due to expenses directly related to the increase in direct written premiums and an increase in occupancy costs. Underwriting expenses as a percentage of direct written premiums was 16.7% in both Q3 2012 and Q3 2011. Our other underwriting expenses increased at the same rate as the growth in our direct written premiums.

Other operating expenses, related to the corporate expenses of our holding company, were \$256,000 in Q3 2012 compared to \$260,000 in Q3 2011. The \$4,000 decrease in Q3 2012 was due nominal net decreases in various overhead expenses.

Interest expense was \$20,000 in Q3 2012 compared to \$24,000 in Q3 2011. The \$4,000 decrease in interest expense was due to the partial redemption of \$703,000 to our 2009/2010 Notes during the quarter ended June 30, 2011, and effective July 11, 2011, a reduction in the interest rate to 9.5% per annum from the previous 12.625% per annum.

Income tax expense in Q3 2012 was \$402,000, which resulted in an effective tax rate of 30.6%. Income tax benefit in Q3 2011 was \$70,000, which resulted in an effective tax rate of (46.4)%. Income before taxes was \$1,316,000 in Q3 2012 compared to \$150,000 in Q3 2011. The increase in the effective tax rate in Q3 2012 is a result of non-taxable permanent differences in Q3 2011 having a greater effect on income tax due the minimal amount of book taxable income in Q3 2011. In addition, we recorded a valuation allowance in Q3 2012 against our state net operating loss carryovers compared to no such allowance in Q3 2011. Kingstone Companies, Inc. generates operating losses for state purposes and has prior year net operating loss carryovers available. KICO, our insurance underwriting subsidiary, is not subject to state income taxes. Valuation allowances totaling of \$98,000 were recorded by us in December 2011 and for the first six months of 2012. An additional valuation allowance of \$26,000 was recorded in Q3 2012. The valuation allowance was established due to the uncertainty of generating enough state taxable income to utilize 100% of our available state net operating loss carryovers over their remaining lives which expire between 2022 and 2027.

Net income was \$914,000 in Q3 2012 compared to \$220,000 in Q3 2011. The increase in net income of \$694,000 was due to the circumstances described above that caused the increases in our net premiums earned and ceding commission revenue, and a decrease in our net loss ratio, offset by increases in our other commission expense and underwriting expenses related to premium growth.

## Insurance Underwriting Business on a Standalone Basis

Our insurance underwriting business reported on a standalone basis for the periods indicated is as follows:

|                                      | Three months ended<br>September 30, |                   | Nine months ended<br>September 30, |                     |
|--------------------------------------|-------------------------------------|-------------------|------------------------------------|---------------------|
|                                      | 2012                                | 2011              | 2012                               | 2011                |
| <b>Revenues</b>                      |                                     |                   |                                    |                     |
| Net premiums earned                  | \$ 5,281,701                        | \$ 3,937,189      | \$ 13,418,808                      | \$ 10,822,137       |
| Ceding commission revenue            | 2,711,431                           | 2,307,390         | 8,525,945                          | 7,347,832           |
| Net investment income                | 242,159                             | 172,039           | 739,555                            | 510,173             |
| Net realized gain on<br>investments  | 65,986                              | 196,574           | 111,546                            | 357,006             |
| Other income                         | 129,788                             | 109,452           | 369,085                            | 307,511             |
| <b>Total revenues</b>                | <b>8,431,065</b>                    | <b>6,722,644</b>  | <b>23,164,939</b>                  | <b>19,344,659</b>   |
| <b>Expenses</b>                      |                                     |                   |                                    |                     |
| Loss and loss adjustment<br>expenses | 2,691,402                           | 2,933,531         | 7,378,421                          | 7,307,925           |
| Commission expense                   | 1,952,583                           | 1,596,281         | 5,430,000                          | 4,472,924           |
| Other underwriting expenses          | 2,134,106                           | 1,734,137         | 5,986,427                          | 5,045,051           |
| Depreciation and amortization        | 150,061                             | 144,122           | 446,503                            | 452,503             |
| <b>Total expenses</b>                | <b>6,928,152</b>                    | <b>6,408,071</b>  | <b>19,241,351</b>                  | <b>17,278,403</b>   |
| <b>Income from operations</b>        | <b>1,502,913</b>                    | <b>314,573</b>    | <b>3,923,588</b>                   | <b>2,066,256</b>    |
| Income tax expense                   | 492,080                             | 30,295            | 1,262,677                          | 601,939             |
| <b>Net income</b>                    | <b>\$ 1,010,833</b>                 | <b>\$ 284,278</b> | <b>\$ 2,660,911</b>                | <b>\$ 1,464,317</b> |

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An analysis of our direct, assumed and ceded earned premiums, loss and loss adjustment expenses, and loss ratios is shown below:

|  | Direct       | Assumed  | Ceded          | Net          |
|--|--------------|----------|----------------|--------------|
| Nine months ended September 30, 2012                                   |              |          |                |              |
| Written premiums   | \$36,439,884 | \$21,553 | \$(21,699,102) | \$14,762,335 |
| Unearned premiums  | (4,017,217)  | (9,119)  | 2,682,809      | (1,343,527)  |
| Earned premiums  | \$32,422,667 | \$12,434 | \$(19,016,293) | \$13,418,808 |
| Loss and loss adjustment expenses excluding the effect of catastrophes |              |          |                |              |
| Catastrophe loss   | \$14,268,577 | \$27,176 | \$(6,917,332)  | \$7,378,421  |
| Loss and loss adjustment expenses                                      | \$14,268,577 | \$27,176 | \$(6,917,332)  | \$7,378,421  |
| Loss ratio excluding the effect of catastrophes                        | 44.0         | % 218.6  | % 36.4         | % 55.0       |
| Catastrophe loss   | 0.0          | % 0.0    | % 0.0          | % 0.0        |
| Loss ratio   | 44.0         | % 218.6  | % 36.4         | % 55.0       |
| Nine months ended September 30, 2011                                   |              |          |                |              |
| Written premiums   | \$30,502,800 | \$6,289  | \$(18,099,446) | \$12,409,643 |
| Unearned premiums  | (3,823,593)  | 1,611    | 2,234,476      | (1,587,506)  |
| Earned premiums  | \$26,679,207 | \$7,900  | \$(15,864,970) | \$10,822,137 |
| Loss and loss adjustment expenses excluding the effect of catastrophes |              |          |                |              |
| Catastrophe loss   | \$12,639,123 | \$15,704 | \$(5,768,974)  | \$6,885,853  |
| Loss and loss adjustment expenses                                      | 1,688,289    | -        | (1,266,217)    | 422,072      |
| Loss ratio excluding the effect of catastrophes                        | \$14,327,412 | \$15,704 | \$(7,035,191)  | \$7,307,925  |
| Catastrophe loss   | 47.4         | % 198.8  | % 36.4         | % 63.6       |
| Loss ratio   | 6.3          | % 0.0    | % 8.0          | % 3.9        |
|  | 53.7         | % 198.8  | % 44.3         | % 67.5       |
| Three months ended September 30, 2012                                  |              |          |                |              |
| Written premiums   | \$12,765,358 | \$18,354 | \$(7,218,500)  | \$5,565,212  |
| Unearned premiums  | (1,363,818)  | (13,031) | 1,093,338      | (283,511)    |
| Earned premiums  | \$11,401,540 | \$5,323  | \$(6,125,162)  | \$5,281,701  |
| Loss and loss adjustment expenses excluding the effect of catastrophes |              |          |                |              |
| Catastrophe loss   | \$4,969,890  | \$12,269 | \$(2,290,757)  | \$2,691,402  |
| Loss and loss adjustment expenses                                      | -            | -        | -              | -            |
| Loss ratio excluding the effect of catastrophes                        | \$4,969,890  | \$12,269 | \$(2,290,757)  | \$2,691,402  |
| Catastrophe loss   | 43.6         | % 230.5  | % 37.4         | % 51.0       |
| Loss ratio   | 0.0          | % 0.0    | % 0.0          | % 0.0        |
|  | 43.6         | % 230.5  | % 37.4         | % 51.0       |
| Three months ended September 30, 2011                                  |              |          |                |              |
| Written premiums   | \$10,382,641 | \$3,409  | \$(6,119,576)  | \$4,266,474  |

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|   |             |         |                |             |
|---|-------------|---------|----------------|-------------|
| Unearned premiums                               | (909,125 )  | (41 )   | 579,881        | (329,285 )  |
| Earned premiums                                 | \$9,473,516 | \$3,368 | \$(5,539,695 ) | \$3,937,189 |
| Loss and loss adjustment expenses exluding      |             |         |                |             |
| the effect of catastrophes                      | \$4,857,144 | \$9,649 | \$(2,355,334 ) | \$2,511,459 |
| Catastrophe loss                                | 1,688,289   | -       | (1,266,217 )   | 422,072     |
| Loss and loss adjustment expenses               | \$6,545,433 | \$9,649 | \$(3,621,551 ) | \$2,933,531 |
| Loss ratio excluding the effect of catastrophes | 51.3        | % 286.5 | % 42.5         | % 63.8      |
| Catastrophe loss                                | 17.8        | % 0.0   | % 22.9         | % 10.7      |
| Loss ratio                                      | 69.1        | % 286.5 | % 65.4         | % 74.5      |

## Key Measures

The key measures for our insurance underwriting business for the periods indicated are as follows:

|  | Three months ended<br>September 30, |             | Nine months ended<br>September 30, |              |
|--|-------------------------------------|-------------|------------------------------------|--------------|
|  | 2012                                | 2011        | 2012                               | 2011         |
| Net premiums earned  | \$5,281,701                         | \$3,937,189 | \$13,418,808                       | \$10,822,137 |
| Ceding commission revenue (1)  | 2,711,431                           | 2,307,390   | 8,525,945                          | 7,347,832    |
| Other income   | 129,788                             | 109,452     | 369,085                            | 307,511      |
| Loss and loss adjustment expenses (2)                                | 2,691,402                           | 2,933,531   | 7,378,421                          | 7,307,925    |
| Acquisition costs and other underwriting expenses:                   |                                     |             |                                    |              |
| Commission expense   | 1,952,583                           | 1,596,281   | 5,430,000                          | 4,472,924    |
| Other underwriting expenses  | 2,134,105                           | 1,734,137   | 5,986,427                          | 5,045,051    |
| Total acquisition costs and other underwriting expenses              | 4,086,688                           | 3,330,418   | 11,416,427                         | 9,517,975    |
| Underwriting income  | \$1,344,830                         | \$90,082    | \$3,518,990                        | \$1,651,580  |
| Key Measures:  |                                     |             |                                    |              |
| Net loss ratio excluding the effect of catastrophes                  | 51.0                                | % 63.8      | % 55.0                             | % 63.6       |
| Effect of catastrophe loss on loss ratio (2)                         | 0.0                                 | % 10.7      | % 0.0                              | % 3.9        |
| Net loss ratio   | 51.0                                | % 74.5      | % 55.0                             | % 67.5       |
| Net underwriting expense ratio excluding the effect of catastrophes  | 23.6                                | % 10.7      | % 18.8                             | % 12.7       |
| Effect of catastrophe loss on net underwriting expense ratio (1) (2) | 0.0                                 | % 12.5      | % 0.0                              | % 4.6        |
| Net underwriting expense ratio                                       | 23.6                                | % 23.2      | % 18.8                             | % 17.2       |
| Net combined ratio excluding the effect of catastrophes              | 74.5                                | % 74.5      | % 73.8                             | % 76.3       |
| Effect of catastrophe loss on net combined ratio (1) (2)             | 0.0                                 | % 23.2      | % 0.0                              | % 8.5        |
| Net combined ratio   | 74.5                                | % 97.7      | % 73.8                             | % 84.7       |
| Reconciliation of net underwriting expense ratio:                    |                                     |             |                                    |              |
| Acquisition costs and other underwriting expenses                    | \$4,086,688                         | \$3,330,418 | \$11,416,427                       | \$9,517,975  |
| Less: Ceding commission revenue (1)                                  | (2,711,431)                         | (2,307,390) | (8,525,945)                        | (7,347,832)  |
| Less: Other income   | (129,788)                           | (109,452)   | (369,085)                          | (307,511)    |
|  | \$1,245,469                         | \$913,576   | \$2,521,397                        | \$1,862,632  |
| Net earned premium   | \$5,281,701                         | \$3,937,189 | \$13,418,808                       | \$10,822,137 |

(1) The effect of catastrophes reduced contingent ceding commission revenue by \$492,870 for the three months and nine months ended September 30, 2011. A provision in our quota share reinsurance treaty, which expired June 30, 2011, limited the maximum contingent ceding commission that could be paid to us, with the unused benefit carried forward to the following treaty year which began July 1, 2011. The carry forward of the unused benefit resulted in additional contingent ceding commission revenue of approximately \$136,000 for the three months and nine months ended September 30, 2011.

(2) Includes net catastrophe losses and net loss adjustment expenses for the three months and nine months ended September 30, 2011 of \$422,072.

## Investments

## Portfolio Summary

The following table presents a breakdown of the amortized cost, aggregate fair value and unrealized gains and losses by investment type as of September 30, 2012 and December 31, 2011:

## Available for Sale Securities

| Category   | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | September 30, 2012<br>Gross Unrealized Losses |                           | Aggregate<br>Fair<br>Value | % of<br>Fair<br>Value |
|--|------------------------------|------------------------------|---|---------------------------|----------------------------|-----------------------|
|  |                              |                              | Less than<br>12<br>Months<br>(unaudited)      | More than<br>12<br>Months |                            |                       |
| Political subdivisions of<br>States,<br>Territories and Possessions                            | \$5,568,774                  | \$290,672                    | \$-   | \$(40,055 )               | \$5,819,391                | 20.5 %                |
| Corporate and other bonds<br>Industrial and miscellaneous                                      | 16,211,308                   | 1,085,116                    | (5,348 )                                      | (8,337 )                  | 17,282,739                 | 61.0 %                |
| Total fixed-maturity<br>securities   | 21,780,082                   | 1,375,788                    | (5,348 )                                      | (48,392 )                 | 23,102,130                 | 81.5 %                |
| Equity Securities  | 4,716,098                    | 550,161                      | (35,366 )                                     | -                         | 5,230,893                  | 18.5 %                |
| Total  | \$26,496,180                 | \$1,925,949                  | \$(40,714 )                                   | \$(48,392 )               | \$28,333,023               | 100.0 %               |
| Category   | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | December 31, 2011<br>Gross Unrealized Losses  |                           | Aggregate<br>Fair<br>Value | % of<br>Fair<br>Value |
|  |                              |                              | Less than<br>12<br>Months                     | More than<br>12<br>Months |                            |                       |
| U.S. Treasury securities and<br>obligations of U.S.<br>government<br>corporations and agencies | \$499,832                    | \$50,356                     | \$-   | \$-                       | \$550,188                  | 2.1 %                 |
| Political subdivisions of<br>States,<br>Territories and Possessions                            | 5,868,743                    | 301,559                      | -   | -                         | 6,170,302                  | 23.2 %                |
| Corporate and other bonds<br>Industrial and miscellaneous                                      | 15,846,616                   | 338,284                      | (228,792 )                                    | (107,666 )                | 15,848,442                 | 59.5 %                |
| Total fixed-maturity<br>securities   | 22,215,191                   | 690,199                      | (228,792 )                                    | (107,666 )                | 22,568,932                 | 84.7 %                |
| Equity Securities  | 3,857,741                    | 311,300                      | (98,938 )                                     | (4,893 )                  | 4,065,210                  | 15.3 %                |
| Total  | \$26,072,932                 | \$1,001,499                  | \$(327,730 )                                  | \$(112,559 )              | \$26,634,142               | 100.0 %               |





Held to Maturity Securities

| Category                 | Cost or Amortized Cost | Gross Unrealized Gains | September 30, 2012 (unaudited)              |                     | Fair Value | % of Fair Value |
|--------------------------|------------------------|------------------------|---|---------------------|------------|-----------------|
|                          |                        |                        | Gross Unrealized Losses Less than 12 Months | More than 12 Months |            |                 |
| U.S. Treasury securities | \$606,273              | \$185,828              | \$-   | \$-                 | \$792,101  | 100.0 %         |

| Category                 | Cost or Amortized Cost | Gross Unrealized Gains | December 31, 2011                           |                     | Fair Value | % of Fair Value |
|--------------------------|------------------------|------------------------|---|---------------------|------------|-----------------|
|                          |                        |                        | Gross Unrealized Losses Less than 12 Months | More than 12 Months |            |                 |
| U.S. Treasury securities | \$606,234              | \$171,719              | \$-   | \$-                 | \$779,953  | 100.0 %         |

Credit Rating of Fixed-Maturity Securities

The table below summarizes the credit quality of our fixed-maturity securities available for sale as of September 30, 2012 and December 31, 2011 as rated by Standard and Poor's.

| Rating                   | September 30, 2012 (unaudited) |                                 |   | December 31, 2011 |                                 |   |
|--------------------------|--------------------------------|---------------------------------|---|-------------------|---------------------------------|---|
|                          | Fair Market Value              | Percentage of Fair Market Value | % | Fair Market Value | Percentage of Fair Market Value | % |
| U.S. Treasury securities | \$-                            | 0.0                             | % | \$550,188         | 2.4                             | % |
| AAA                      | 3,002,082                      | 13.0                            | % | 3,041,576         | 13.5                            | % |
| AA                       | 3,914,821                      | 16.9                            | % | 4,502,733         | 20.0                            | % |
| A                        | 6,691,583                      | 29.0                            | % | 6,977,222         | 30.9                            | % |
| BBB                      | 9,493,644                      | 41.1                            | % | 7,497,213         | 33.2                            | % |
| Total                    | \$23,102,130                   | 100.00                          | % | \$22,568,932      | 100.0                           | % |

The table below summarizes the average duration by type of fixed-maturity security available for sale as well as detailing the average yield as of September 30, 2012 and December 31, 2011:

| Category  | September 30, 2012 |                                    | December 31, 2011 |                                    |
|---|--------------------|------------------------------------|-------------------|------------------------------------|
|   | Average Yield %    | Weighted Average Duration in Years | Average Yield %   | Weighted Average Duration in Years |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 3.28 %             | 28.0                               | 2.75 %            | 17.8                               |
| Political subdivisions of States, Territories and Possessions                         | 4.11 %             | 4.7                                | 3.86 %            | 5.2                                |
| Corporate and other bonds<br>Industrial and miscellaneous                             | 4.76 %             | 6.6                                | 4.98 %            | 7.1                                |

#### Fair Value Consideration

As disclosed in Note 4 to the Condensed Consolidated Financial Statements, with respect to “Fair Value Measurements,” we define fair value under GAAP guidance as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (an “exit price”). This GAAP guidance establishes a fair value hierarchy that distinguishes between inputs based on market data from independent sources (“observable inputs”) and a reporting entity’s internal assumptions based upon the best information available when external market data is limited or unavailable (“unobservable inputs”). The fair value hierarchy in GAAP prioritizes fair value measurements into three levels based on the nature of the inputs. Quoted prices in active markets for identical assets have the highest priority (“Level 1”), followed by observable inputs other than quoted prices including prices for similar but not identical assets or liabilities (“Level 2”), and unobservable inputs, including the reporting entity’s estimates of the assumption that market participants would use, having the lowest priority (“Level 3”). As of September 30, 2012 and December 31, 2011, 48% and 49%, respectively, of the investment portfolio recorded at fair value was priced based upon quoted market prices.

As more fully described in Note 3 to our Condensed Consolidated Financial Statements, “Investments—Impairment Review,” we completed a detailed review of all our securities in a continuous loss position as of September 30, 2012 and December 31, 2011, and concluded that the unrealized losses in these asset classes are the result of a decrease in value due to technical spread widening and broader market sentiment, rather than fundamental collateral deterioration, and are temporary in nature.

The table below summarizes the gross unrealized losses of our fixed-maturity securities available for sale and equity securities by length of time the security has continuously been in an unrealized loss position as of September 30, 2012 and December 31, 2011:

| Category  | Less than 12 months |                   |                       | September 30, 2012<br>12 months or more |                   |                       | Total                |                   |
|---|---------------------|-------------------|-----------------------|---|-------------------|-----------------------|----------------------|-------------------|
|   | Fair Value          | Unrealized Losses | No. of Positions Held | Fair Value                              | Unrealized Losses | No. of Positions Held | Aggregate Fair Value | Unrealized Losses |
| Fixed-Maturity Securities:                                    |                     |                   |                       |   |                   |                       |                      |                   |
| Political subdivisions of States, Territories and Possessions | \$-                 | \$ -              | -                     | \$764,668                               | \$ (40,055 )      | 2                     | \$764,668            | \$ (40,055 )      |
| Corporate and other bonds industrial and miscellaneous        | 877,005             | (5,348 )          | 3                     | 370,758                                 | (8,337 )          | 2                     | 1,247,763            | (13,685 )         |
| Total fixed-maturity securities                               | \$877,005           | \$ (5,348 )       | 3                     | \$1,135,426                             | \$ (48,392 )      | 4                     | \$2,012,431          | \$ (53,740 )      |
| Equity Securities:  |                     |                   |                       |   |                   |                       |                      |                   |
| Preferred stocks  | \$386,950           | \$ (8,977 )       | 3                     | \$-                                     | \$ -              | -                     | \$386,950            | \$ (8,977 )       |
| Common stocks   | 439,205             | (26,389 )         | 3                     | -                                       | -                 | -                     | 439,205              | (26,389 )         |
| Total equity securities                                       | \$826,155           | \$ (35,366 )      | 6                     | \$-                                     | \$ -              | -                     | \$826,155            | \$ (35,366 )      |
| Total   | \$1,703,160         | \$ (40,714 )      | 9                     | \$1,135,426                             | \$ (48,392 )      | 4                     | \$2,838,586          | \$ (89,106 )      |

| Category  | Less than 12 months |                    |                       | December 31, 2011<br>12 months or more |                    |                       | Total                |                    |
|---|---------------------|--------------------|-----------------------|--|--------------------|-----------------------|----------------------|--------------------|
|   | Fair Value          | Unrealized Losses  | No. of Positions Held | Fair Value                             | Unrealized Losses  | No. of Positions Held | Aggregate Fair Value | Unrealized Losses  |
| <b>Fixed-Maturity Securities:</b>   |                     |                    |                       |  |                    |                       |                      |                    |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$-                 | \$-                | -                     | \$-                                    | \$-                | -                     | \$-                  | \$-                |
| Political subdivisions of States, Territories and Possessions                         | -                   | -                  | -                     | -                                      | -                  | -                     | -                    | -                  |
| Corporate and other bonds industrial and miscellaneous                                | 4,849,378           | (228,792)          | 26                    | 1,483,425                              | (107,666)          | 7                     | 6,332,803            | (336,458)          |
| <b>Total fixed-maturity securities</b>  | <b>\$4,849,378</b>  | <b>\$(228,792)</b> | <b>26</b>             | <b>\$1,483,425</b>                     | <b>\$(107,666)</b> | <b>7</b>              | <b>\$6,332,803</b>   | <b>\$(336,458)</b> |
| <b>Equity Securities:</b>   |                     |                    |                       |  |                    |                       |                      |                    |
| Preferred stocks  | \$368,350           | \$(76,969)         | 12                    | \$189,364                              | \$(4,893)          | 5                     | \$557,714            | \$(81,862)         |
| Common stocks   | 397,268             | (21,969)           | 14                    | -                                      | -                  | -                     | 397,268              | (21,969)           |
| <b>Total equity securities</b>  | <b>\$765,618</b>    | <b>\$(98,938)</b>  | <b>26</b>             | <b>\$189,364</b>                       | <b>\$(4,893)</b>   | <b>5</b>              | <b>\$954,982</b>     | <b>\$(103,831)</b> |
| <b>Total</b>  | <b>\$5,614,996</b>  | <b>\$(327,730)</b> | <b>52</b>             | <b>\$1,672,789</b>                     | <b>\$(112,559)</b> | <b>12</b>             | <b>\$7,287,785</b>   | <b>\$(440,289)</b> |

There were 13 securities at September 30, 2012 that accounted for the gross unrealized loss, none of which were deemed by us to be other than temporarily impaired. There were 64 securities at December 31, 2011 that accounted for the gross unrealized loss, none of which were deemed by us to be other than temporarily impaired. Significant factors influencing our determination that unrealized losses were temporary included the magnitude of the unrealized losses in relation to each security's cost, the nature of the investment and management's intent not to sell these securities and it being not more likely than not that we will be required to sell these investments before anticipated recovery of fair value to our cost basis.

## Liquidity and Capital Resources

### Cash Flows

The primary sources of cash flow are from our insurance underwriting subsidiary, KICO, which includes direct premiums written, ceding commissions from our quota share reinsurers, loss recovery payments from our reinsurers, investment income and proceeds from the sale or maturity of investments. Funds are used by KICO for ceded premium payments to reinsurers, which are paid on a net basis after subtracting losses paid on reinsured claims and reinsurance commissions. KICO also uses funds for loss payments and loss adjustment expenses on our net business, commissions to producers, salaries and other underwriting expenses as well as to purchase investments and fixed assets.

On July 1, 2009, we completed the acquisition of 100% of the issued and outstanding common stock of KICO (formerly known as Commercial Mutual Insurance Company ("CMIC")) pursuant to the conversion of CMIC from an advance premium cooperative to a stock property and casualty insurance company. Pursuant to the plan of conversion, we acquired a 100% equity interest in KICO. In connection with the plan of conversion of CMIC, we agreed with the Department of Financial Services (formerly known as the Insurance Department) (the "Department") that, for a period of two years following the effective date of conversion of July 1, 2009, no dividend could be paid by KICO to us without the approval of the Department ("Dividend Restriction Period"). No such request was made by us to the Department within the dividend restriction period. For the nine months ended September 30, 2012, KICO paid dividends of \$700,000 to us. We also agreed with the Department that certain intercompany transactions between KICO and us must be filed with the Department 30 days prior to implementation and not disapproved by the Department.

During the nine months ended September 30, 2012 we declared and paid \$380,046 of dividends on our Common Stock. Our Board of Directors approved a quarterly dividend on November 12, 2012 at the rate of \$.04 per share payable in cash on December 14, 2012 to stockholders of record as of November 30, 2012.

The primary sources of cash flow for our holding company operations are in connection with the fee income we receive from the premium finance loans and collection of principal and interest income from the notes received by us upon the sale of businesses that were included in our former discontinued operations. Effective July 1, 2011, as discussed above, we may also receive cash dividends from KICO, subject to statutory restrictions.

In December 2011, we entered into an agreement with a bank for a \$500,000 line of credit to be used for general corporate needs. The principal balance is payable on demand, and must be reduced to zero for a minimum of 30 consecutive days during each year of the term of the credit line. The principal balance was reduced to zero in accordance with the terms of the credit line during the three months ended September 30, 2012. The outstanding balance was \$350,000 as of September 30, 2012. If the aforementioned is insufficient to cover our holding company cash requirements, we will seek to obtain additional financing.

We prepaid \$703,000 of our notes payable during the year ended December 31, 2011. As of September 30, 2012, the outstanding principal balance of our notes payable was \$747,000; such notes bear interest at the rate of 9.5% per annum and mature on July 10, 2014. We believe that our present cash flows as described above will be sufficient on a short-term basis and over the next 12 months to fund our company-wide working capital requirements.

Our reconciliation of net income to cash provided by operations is generally influenced by the collection of premiums in advance of paid losses, the timing of reinsurance, issuing company settlements and loss payments.

Cash flow and liquidity are categorized into three sources: (1) operating activities; (2) investing activities; and (3) financing activities, which are shown in the following table:

| Nine Months Ended September 30,                | 2012         | 2011         |
|--|--------------|--------------|
| Cash flows provided by (used in):              |              |              |
| Operating activities                           | \$ 2,953,088 | \$ 5,790,641 |
| Investing activities                           | (392,160 )   | (2,257,043 ) |
| Financing activities                           | (286,205 )   | (829,150 )   |
| Net increase in cash and cash equivalents      | 2,274,723    | 2,704,448    |
| Cash and cash equivalents, beginning of period | 173,126      | 326,620      |
| Cash and cash equivalents, end of period       | \$ 2,447,849 | \$ 3,031,068 |

Net cash provided by operating activities was \$2,953,000 in 2012 as compared to \$5,791,000 provided in 2011. The \$2,838,000 decrease in cash flows provided by operating activities in 2012 was primarily a result of the fluctuations in assets and liabilities relating to operating activities of KICO as affected by the growth in its operations which are described above, offset by an increase in net income (adjusted for non-cash items) of \$1,424,000.

Net cash used by investing activities was \$392,000 in 2012 compared to \$2,257,000 used in 2011. The \$1,865,000 increase in cash flows provided by investing activities is a result of the decrease in acquisitions, offset by a decrease in sales of invested assets.

Net cash used in financing activities was \$286,000 in 2012 compared to \$829,000 used in 2011. The \$543,000 decrease in cash flows used in financing activities is a result of principal payments on long term debt of \$714,000 in 2011 compared to no such payments in 2012, and dividend payments of \$380,000 in 2012 compared to \$115,000 in 2011.

#### Superstorm Sandy

The primary location of KICO's insureds is in the New York City area, which was struck by Superstorm Sandy on October 29, 2012. KICO purchases quota share and catastrophe reinsurance in order to reduce its net liability on insurance risks and to protect against catastrophes. KICO's personal lines business, which includes homeowners insurance, is reinsured under a 75% quota share treaty and catastrophe insurance pursuant to which KICO's net liability is limited to 25% of the initial \$3,000,000 of direct losses incurred from an occurrence, or \$750,000. For catastrophe losses in excess of \$3,000,000, KICO is 100% covered by catastrophe reinsurance with regard to the next \$70,000,000 in losses. We estimate that KICO's net loss incurred as a result of the storm will be \$750,000 with respect to KICO's personal lines business, which is the limit of loss pursuant to its quota share and catastrophe reinsurance treaties. Additional losses will be incurred with respect to KICO's commercial auto and livery physical damage policies.

KICO receives ceding commissions from the reinsurers. The amount of the commissions includes contingent ceding commissions which are based upon the loss ratio experienced by the reinsurers during the treaty term (July 1 to June 30) from the ceded business over that period of time. During the three month period ended September 30, 2012 (which was the initial quarter of the 2012-2013 treaty year), our revenue includes contingent ceding commission revenue of \$755,000. Such contingent ceding commission revenue is subject to downward adjustment (to possibly less than zero) based upon the reinsurance losses expected to be incurred as a result of Superstorm Sandy. In addition, it is expected

that there will be a significant decline in the ceding commission revenue to be earned during the 4th quarter of 2012 and the first two quarters of 2013 (i.e., the final nine months of the 2012-2013 treaty); however, the amount cannot yet be reasonably estimated due to the high volume of claims that KICO has already received and the anticipation of many more to follow. Further, KICO will be required to pay reinstatement premiums to catastrophe reinsurers to obtain coverage for future catastrophe events during the current reinsurance treaty period. Accordingly, the effects of the storm will be material to our post-3rd quarter of 2012 results of operations; however, we expect that, based upon our results of operations for the three and nine months ended September 30, 2012, such effects will not have a material adverse impact on our financial condition. See “Factors Relating to Superstorm Sandy That May Affect Future Results and Financial Condition” below.



#### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

#### Factors Relating to Superstorm Sandy That May Affect Future Results and Financial Condition

Based upon the following factors relating to Superstorm Sandy, the factors set forth under “Factors That May Affect Future Results and Financial Condition” in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011, as well as other factors affecting our operating results and financial condition, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods. In addition, such factors, among others, may affect the accuracy of certain forward-looking statements contained in this Quarterly Report.

The effects of Superstorm Sandy will be material to our post-3rd quarter of 2012 results of operations.

On October 29, 2012, the New York City area, which is the primary location of KICO’s insureds, was struck by Superstorm Sandy. Certain material effects of the storm on our post-3rd quarter of 2012 results of operations are described under “Liquidity and Capital Resources - Superstorm Sandy” above. Given its recent occurrence and the limited information currently available, we cannot provide a reasonable estimate of the ongoing effects of the storm; however, given the likely reinsurance losses that will be incurred as a result of the storm, it is possible that the terms and conditions for any reinsurance that we may require following the end of our current reinsurance treaties on June 30, 2013 will be impacted.

#### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable

#### ITEM 4. CONTROLS AND PROCEDURES.

##### Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) that are designed to assure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

As required by Exchange Act Rule 13a-15(b), as of the end of the period covered by this Annual Report, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2012.

##### Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS.

None

## ITEM 1A. RISK FACTORS.

Not applicable. See, however, “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Factors Relating to Superstorm Sandy That May Affect Future Results and Financial Condition” in Item 2 of Part I of this Quarterly Report.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

(a) None

(b) Not applicable

(c) The following table sets forth certain information with respect to purchases of common stock made by us or any “affiliated purchaser” during the quarter ended September 30, 2012:

| Period           | Total Number of Shares Purchased <sup>(1)</sup> | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Be Purchased Under the Plans or Programs |
|------------------|---|------------------------------|--|--|
| 7/1/12 - 7/31/12 | -   | -                            | -  | -  |
| 8/1/12 – 8/31/12 | 4,602   | \$4.98                       | -  | -  |
| 9/1/12 - 9/30/12 | 4,600   | \$4.78                       | -  | -  |
| Total            | 9,202   | \$4.88                       | -  | -  |

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None

## ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable

## ITEM 5. OTHER INFORMATION.

None



ITEM 6. EXHIBITS.

3(a) Restated Certificate of Incorporation, as amended<sup>1</sup>

3(b) By-laws, as amended<sup>2</sup>

31(a) Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31(b) Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive Officer and Chief Financial Officer Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

<sup>1</sup> Denotes document filed as an exhibit to our Quarterly Report on Form 10-Q for the period ended March 31, 2012 and incorporated herein by reference.

<sup>2</sup> Denotes document filed as an exhibit to our Current Report on Form 8-K for an event dated November 5, 2009 and incorporated herein by reference.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KINGSTONE COMPANIES, INC.

Dated: November 14, 2012

By: /s/ Barry B. Goldstein  
Barry B. Goldstein  
President

By: /s/ Victor Brodsky  
Victor Brodsky  
Chief Financial Officer