

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

AMERICAN PHYSICIANS SERVICE GROUP INC

Form 10KSB

March 30, 2004

=====

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-KSB

--X-- Annual Report Pursuant to Section 13 or 15(d) of the Securities  
Exchange Act of 1934 for the fiscal year ended December 31, 2003  
----- Transition Report Pursuant to Section 13 or 15(d) of the Securities  
Exchange Act of 1934

Commission File Number: 0-11453

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
(Exact name of registrant as specified in its charter)

Texas 75-1458323  
(State or other jurisdiction (I.R.S. employer Identification No.)  
of incorporation or organization)

1301 Capital of Texas Highway, Austin Texas 78746  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (512) 328-0888  
Securities registered pursuant to Section 12(b) of the Act:

Title of each class -----	Name of each exchange on which registered -----
None	None

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, \$0.10 par value

(Title of Class)

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

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

State the aggregate market value of the voting stock held by non-affiliates of the registrant. The aggregate market value shall be computed by reference to the price at which the stock was sold or the average bid and asked prices of such stock, as of a specified date within 60 days prior to the date of filing.

Aggregate Market Value at March 10, 2004: \$23,063,627

Indicate the number of shares outstanding of each of the registrant's class of common stock, as of the latest practicable date.

Number of Shares

# Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Title of Each Class -----	Outstanding At March 10, 2004 -----
Common Stock, \$.10 par value	2,478,667

Documents Incorporated By Reference Selected portions of the Registrant's definitive proxy material for the 2003 annual meeting of shareholders are incorporated by reference into Part III of the Form 10-KSB.

## TABLE OF CONTENTS

	PAGE
PART I	
Item 1. Description of Business	3
Item 2. Description of Property	9
Item 3. Legal Proceedings	9
Item 4. Submission of Matters to a Vote of Security Holders	9
PART II	
Item 5. Market for Common Equity Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities	9
Item 6. Management's Discussion and Analysis or Plan of Operation	10
Item 7. Financial Statements	19
Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	19
Item 8A. Controls and Procedures	19
PART III	
Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act	19
Item 10. Executive Compensation	19
Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	19
Item 12. Certain Relationships and Related Transactions	19
Item 13. Exhibits, Lists and Reports on Form 8-K	20
Item 14. Principal Accountant Fees and Services	23
SIGNATURES	23
EXHIBIT INDEX	A-1

# Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

EX-21.1 (Subsidiaries of the Registrant)  
EX-23.1 (Consents of Experts and Counsel)  
EX-31.1 (Certification of Chief Executive Officer)  
EX-31.2 (Certification of Chief Financial Officer)  
EX-32.1 (Certification of Chief Executive Officer)  
EX-32.2 (Certification of Chief Financial Officer)

2

AMERICAN PHYSICIANS SERVICE GROUP, INC.

ANNUAL REPORT ON FORM 10-KSB

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003

References in this report to "we", "us", "our", and the "Company" mean American Physicians Service Group, Inc.

## PART I

### ITEM 1. DESCRIPTION OF BUSINESS

#### GENERAL

We, through our subsidiaries, provide services that include brokerage and investment services to individuals and institutions, and management and agency services to malpractice insurance companies.

We were organized in October 1974 under the laws of the State of Texas. Our principal executive office is at 1301 Capital of Texas Highway, Suite C-300, Austin, Texas 78746, and our telephone number is (512) 328-0888. Our website is [www.amph.com](http://www.amph.com). We make available free of charge on our website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission ("SEC")

Financial information about our industry segments is disclosed in Note 16 to our accompanying Consolidated Financial Statements in Appendix A.

#### OUR FINANCIAL SERVICES

Through our subsidiaries, APS Financial Corporation, or APS Financial, and APS Asset Management, Inc., or Asset Management, we provide investment and investment advisory services to institutions and individuals throughout the United States. Our revenues from this segment were 64% and 59% of our total revenues in 2003 and 2002, respectively.

APS Financial is a fully licensed broker/dealer that provides brokerage and investment services primarily to institutional and high net worth individual clients. APS Financial also provides portfolio accounting, analysis, and other

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

services, to insurance companies, banks, and public funds. APS Financial has its main office in Austin, Texas with branch offices in Houston, Texas and Redmond, Washington.

APS Financial charges commissions on both exchange and over-the-counter, or OTC, transactions in accordance with industry practice. When APS Financial executes OTC transactions as a dealer, it receives, in lieu of commissions, markups or markdowns.

APS Financial is a member of the National Association of Securities Dealers, Inc., or NASD, the Securities Investor Protection Corporation, or SIPC, the Securities Industry Association, and, in addition, is licensed in 44 states and Washington D.C.

3

Every registered broker/dealer doing business with the public is subject to stringent rules with respect to net capital requirements promulgated by the Securities and Exchange Commission, or SEC. These rules, which are designed to measure the financial soundness and liquidity of broker/dealers, specify minimum net capital requirements. Since we (as opposed to APS Financial) are not a registered broker/dealer, we are not subject to these rules. However, APS Financial is subject to these rules. Compliance with applicable net capital requirements could limit APS Financial's operations, such as limiting or prohibiting trading activities that require the use of significant amounts of capital. A significant operating loss or an extraordinary charge against net capital could adversely affect the ability of APS Financial to expand or even maintain its present levels of business. At February 28, 2004, APS Financial was in compliance with all applicable net capital requirements.

APS Financial clears its transactions through SWS Securities, Inc., or SWS, on a fully disclosed basis. SWS also processes orders and floor reports, matches trades, transmits execution reports to APS Financial and records all data pertinent to trades. APS Financial pays SWS a fee based on the number and type of transactions.

Asset Management, a registered investment adviser under the Investment Advisers Act of 1940, was formed and registered with the SEC in 1998. We formed Asset Management to manage fixed income and equity assets for institutional and individual clients on a fee basis. Asset Management's mission is to provide clients with investment results within specific client-determined risk parameters.

### OUR INSURANCE SERVICES

As of December 31, 2003, APS Insurance Services, Inc., or Insurance Services, is a wholly-owned subsidiary of ours. Prior to October 1, 2003, we owned 80% of Insurance Services. On October 1, 2003 we acquired the remaining 20% minority interest in APS Insurance Services for approximately \$2.0 million in cash (see Note 14). APS Insurance Services, through its wholly-owned subsidiaries APS Facilities Management, Inc., dba APMC Insurance Services, Inc., or FMI, and American Physicians Insurance Agency, Inc., or Agency, provides management and agency services to medical malpractice insurance companies. Our revenues from this segment contributed 36% and 41% of our total revenues in 2003 and 2002, respectively.

Substantially all of our revenue from this segment was attributable to FMI providing management services to American Physicians Insurance Exchange, or APIE, a reciprocal insurance exchange, wholly-owned by its subscriber physicians. A reciprocal insurance exchange is an organization that sells insurance only to its subscribers, who pay, in addition to their annual insurance premiums, a

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

contribution to the exchange's surplus. These exchanges generally have no paid employees but instead enter into a contract with an "attorney-in-fact" that provides all management and administrative services for the exchange. As the attorney-in-fact for APIE, FMI receives a percentage of the earned premiums of APIE, as well as a portion of APIE's profits. The amount of these premiums can be adversely affected by competition. Substantial underwriting losses, which might result in a curtailment or cessation of operations by APIE, would also adversely affect FMI's revenue and, accordingly, our revenue. To limit possible underwriting losses, APIE currently reinsures its risk in excess of \$250,000 per medical incident. APIE offers medical professional liability insurance for physicians in Texas and Arkansas. FMI's assets are not subject to any insurance claims by policyholders of APIE.

APIE was organized in 1975, and FMI has been its exclusive manager since its inception. The management agreement between FMI and APIE basically provides for full management by FMI of the affairs of APIE under the direction of APIE's physician board of directors. Subject to the direction of this board, FMI sells and issues policies, investigates, settles and defends claims, and otherwise manages APIE's affairs. In consideration for performing its services, FMI receives a percentage fee based on APIE's earned premiums (before payment of reinsurance premiums), as well as a portion of APIE's profits. FMI pays salaries and personnel related expenses, rent and office operations costs, data processing costs and many other operating expenses of APIE. APIE is responsible for the payment of all claims, claims expenses, peer review expenses, directors' fees and expenses, legal, actuarial and auditing expenses, its taxes, outside agent commissions and certain other specific expenses. Under the management agreement, FMI's authority to act as manager of APIE is automatically renewed each year unless a majority of the subscribers to APIE elect to terminate the

4

management agreement by reason of an adjudication that FMI has been grossly negligent, has acted in bad faith or with fraudulent intent or has committed willful misfeasance in its management activities. Termination of FMI's management agreement with APIE would have a material adverse effect on us.

APIE is authorized to do business in the states of Texas and Arkansas, and specializes in writing medical professional liability insurance for health care providers. It writes insurance in Texas primarily through purchasing groups and is not subject to certain rate and policy form regulations issued by the Texas Department of Insurance. It reviews applicants for insurance coverage based on the nature of their practices, prior claims records and other underwriting criteria. APIE is one of the largest medical professional liability insurance companies in the State of Texas. APIE is the only professional liability insurance company based in Texas that is wholly-owned by its subscriber physicians.

Generally, medical professional liability insurance is offered on either a "claims made" basis or an "occurrence" basis. "Claims made" policies insure physicians only against claims that occur and that are reported during the period covered by the policy. "Occurrence" policies insure physicians against claims based on occurrences during the policy period regardless of when they are reported. APIE offers only a "claims made" policy in Texas and Arkansas, but provides for an extended reporting option upon termination. APIE reinsures 100% of all Texas and Arkansas coverage per medical incident between \$250,000 and \$1,000,000, primarily through certain domestic and international insurance companies.

The following table presents selected financial and other data for APIE. The management agreement with FMI obligates APIE to pay management fees to FMI based on APIE's earned premiums before payment of reinsurance premiums. The

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

management fee percentage is 13.5% with the provision that any profits of APIE will be shared equally with FMI so long as the total payment (fees and profit sharing) does not exceed a cap based on premium levels. In 2003, 2002, 2001, 2000, and 1999, management fees attributable to profit sharing were \$722,000, \$0, \$0, \$0, and \$329,000, respectively. While APIE was profitable in 2001 and 2002 there was no profit sharing with FMI due to the management agreement requiring that prior year losses be applied against future pretax income. Only after prior year losses are completely offset can FMI then share equally the profits at APIE.

	Years Ended December 31		
	2003	2002	2001
	(Unaudited, in thousand, except for)		
Earned premiums before reinsurance premiums	\$ 51,904	\$ 46,078	\$ 35,866
Total assets	102,728	80,721	64,557
Total surplus	15,783	12,985	11,475
Management fees (including profit sharing) and commissions to FMI and Agency (1)	7,789	6,221	5,084
Number of insureds	3,073	3,181	3,101

(1) Includes commissions of \$513, \$3,103, \$2,886, \$1,898, and \$1,191 in 2003, 2002, 2001, 2000, and 1999, respectively, from other carriers directly related to APIE's controlled business.

### OUR OTHER INVESTMENTS

At December 31, 2003, we owned less than 5% of the outstanding common stock of Prime Medical Services, Inc., or Prime Medical, having reduced our ownership from 15% with the sale of 1,591,000 shares during 2002. Prior to that sale we recorded our pro-rata share of Prime Medical's earnings using the equity method of accounting. As a result of our reduced ownership, we now account for our investment as an available-for-sale equity security, with changes in market value, net of tax, reflected in shareholders' equity as "accumulated other

5

comprehensive income." Prime Medical is the largest provider of lithotripsy services in the United States, currently servicing over 372 hospitals and surgery centers in 26 states. Lithotripsy is a non-invasive method of treating kidney stones through the use of shock waves. Prime is also an international supplier of specialty vehicles for the transport of high technology medical, broadcast/communications and homeland security equipment. At December 31, 2003, our investments in Prime Medical Securities include common stock and fixed income securities with an aggregate fair market value of \$4,313,000. A material decline in the value of this investment could have a material effect in our financial condition and results of operations.

The common stock of Prime Medical is quoted on the NASDAQ National Market under the symbol "PMSI". Prime Medical is a Delaware corporation and is required to file annual, quarterly and other reports and documents with the SEC. The summary information in the accompanying consolidated financial statements

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

regarding Prime Medical is qualified in its entirety by reference to such reports and documents. Such reports and documents may be examined and copies may be obtained from the SEC.

On June 4, 2003 we purchased from Financial Industries Corporation ("FIC") (NASDAQ: FNIN) and a foundation 339,879 shares of FIC's common stock as an investment. The purchase price was approximately \$5,000,000, which was sourced from our cash reserves. Earlier in 2003 we had purchased 45,121 FIC shares in the open market. The 385,000 shares represents an approximate 4% ownership in FIC. The shares purchased from FIC and the foundation are not registered, but are subject to a registration rights agreement requiring FIC's best efforts to register them within one year of the transaction. We have classified all of these shares as securities available-for-sale and have recorded changes in their value, net of tax, in our balance sheet as part of "accumulated other comprehensive income". A material decline in the value of this investment could have a material effect in our financial condition and results of operations. At December 31, 2003, the fair market value of our investment in FIC stock was \$5,313,000.

As part of this transaction we were granted options to purchase an additional 323,000 shares of FIC's common stock at \$16.42 per share. There is a significant revenue-related performance requirement that must be met before these options are exercisable. We have assigned no value to this option.

FIC is a Texas corporation and is required to file annual, quarterly and other reports and documents with the SEC. (The summary information in the accompanying consolidated financial statements regarding FIC is qualified in its entirety by reference to such reports and documents.) Such reports and documents may be obtained from the SEC.

### DISCONTINUED OPERATIONS

Effective November 1, 2002, we completed the sale of APS Consulting to its management as we determined the division's operations were not consistent with our long-term strategic plan. We sold all of our APS Consulting shares for a de minimus amount of cash plus a \$250,000 seven-year term note at the prime rate plus 3%. Our existing contract, which was entered into October 1, 2002, provides administrative support services to APS Consulting for a period of approximately seven years remains in effect. Fees under this contract are dependent on APS Consulting's pre-tax earnings but may not be less than \$200,000 or more than \$518,000 over the life of the agreement. Because we were dependent upon the future successful operation of the division to collect our proceeds from the disposal and because we had a security interest in the assets of the division, we had retained a sufficient risk of loss to preclude us from recognizing the divestiture of APS Consulting under the guidance of FASB Interpretation No 46. Accordingly, we did not recognize the divestiture of APS Consulting and continued to consolidate the division as an entity in which we have a variable interest that will absorb the majority of the entity's operating losses if they occurred.

Effective November 1, 2003, APS Consulting was able to obtain third party financing and repay their note payable to us in exchange for our agreeing to discount the note by \$35,000. We provided no guarantees or credit enhancements in connection with APS Consulting securing this financing. Accordingly, we no

longer have a risk of loss related to these operations and have recognized the transaction as a divestiture. As a result, we ceased consolidation of APS

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Consulting financial statements effective November 1, 2003. In addition, we were able to recognize a gain of \$27,000, net of tax, and administrative support fees totaling \$84,000 for the period from November 1, 2002 through October 31, 2003 that had previously been eliminated as intercompany revenues.

### COMPETITION

APS Financial and Asset Management are both engaged in a highly competitive business. Their competitors include, with respect to one or more aspects of their business, all of the member organizations of the New York Stock Exchange and other registered securities exchanges, all members of the NASD, registered investment advisors, members of the various commodity exchanges and commercial banks and thrift institutions. Many of these organizations are national rather than regional firms and have substantially greater personnel and financial resources than us. In many instances APS Financial is competing directly with these organizations. In addition, there is competition for investment funds from the real estate, insurance, banking and thrift industries.

APIE competes with Medical Protective Insurance Company, Texas Medical Liability Trust, and the Texas Medical Liability Insurance Underwriting Association (JUA), which is the State sponsored insurer of last resort. APIE does not have the capacity to write the volume of business equal to that of the other major carriers. Great focus has been given to the area of underwriting and the selection of our insured physicians. With the successful passing of tort reform in late 2003, there is an increased likelihood of additional companies re-entering the Texas market. APIE anticipates maintaining its market share through a combination of unique and tailored coverages, and a continued commitment to claims, risk management and underwriting services.

### REGULATION

APS Financial and Asset Management are subject to extensive regulation under both federal and state laws. The SEC is the federal agency charged with administration of the federal securities and investment advisor laws. Much of the regulation of broker/dealers, however, has been delegated to self-regulatory organizations, principally the NASD and the national securities exchanges. These self-regulatory organizations adopt rules (subject to approval by the SEC), which govern the industry and conduct periodic examinations of member broker/dealers. APS Financial is also subject to regulation by state and District of Columbia securities commissions.

The regulations to which APS Financial is subject cover all aspects of the securities business, including sales methods, trade practices among broker/dealers, uses and safekeeping of customers' funds and securities, capital structure of securities firms, record keeping and the conduct of directors, officers and employees. Additional legislation, changes in rules promulgated by the SEC and by self-regulatory organizations, or changes in the interpretation or enforcement of existing laws and rules, may directly affect the method of operation and profitability of APS Financial and, accordingly, us. The SEC, self regulatory organizations and state securities commissions may conduct administrative proceedings which can result in censure, fine, suspension or expulsion of APS Financial, its officers or employees. The principal purpose of regulation and discipline of broker/dealers is the protection of customers and the securities markets, rather than protection of creditors and shareholders of broker/dealers.

APS Financial, as a registered broker/dealer and NASD member organization, is required by federal law to belong to the SIPC. When the SIPC fund falls below a certain minimum amount, members are required to pay annual assessments in varying amounts not to exceed .5% of their adjusted gross revenues to restore the fund. The SIPC fund provides protection for customer accounts up to \$500,000



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

per customer, with a limitation of \$100,000 on claims for cash balances.

FMI has received certificates of authority from the Texas and Arkansas insurance departments, licensing it on behalf of the subscribers of APIE. APIE,

7

as an insurance company, is subject to regulation by the insurance departments of the States of Texas and Arkansas. These regulations strictly limit all financial dealings of a reciprocal insurance exchange with its officers, directors, affiliates and subsidiaries, including FMI. Premium rates, advertising, solicitation of insurance, types of insurance issued and general corporate activity are also subject to regulation by various state agencies.

### EMPLOYEES

At March 1, 2004, we employed, on a full time basis, approximately 107 persons, including 56 by Insurance Services, 42 by APS Financial and Asset Management, and 9 directly by us. We consider our employee relations to be good. None of our employees are represented by a labor union and we have experienced no work stoppages.

### EXECUTIVE OFFICERS

As of March 15, 2004, our executive officers were as follows:

Name	Age	Position
Kenneth S. Shifrin	54	Chairman of the Board, President and Chief Executive Officer
William H. Hayes	56	Senior Vice President -Finance, Secretary, Chief Financial Officer
Maury L. Magids	39	Senior Vice President - Insurance
Thomas R. Solimine	45	Controller

Our officers serve until the next annual meeting of our directors and until their successors are elected and qualified.

Mr. Shifrin has been our Chairman of the Board since March 1990. He has been our President and Chief Executive Officer since March 1989 and he was President and Chief Operating Officer from June 1987 to February 1989. He has been a director of ours since February 1987. From February 1985 until June 1987, Mr. Shifrin served as our Senior Vice President - Finance and Treasurer. Mr. Shifrin also has been a director of Financial Industries Corporation since June 2003 and Chairman of the Board of Prime Medical since October 1989. Mr. Shifrin is a member of the World Presidents Organization.

Mr. Hayes has been our Senior Vice President - Finance since June 1995. Mr. Hayes was our Vice President from June 1988 to June 1995 and was our Controller from June 1985 to June 1987. He has been our Secretary since February 1987 and our Chief Financial Officer since June 1987. Mr. Hayes is a Certified Public Accountant.

Mr. Magids has been our Senior Vice President - Insurance Services since June 2001 and has been President and Chief Operating Officer of FMI since November 1998. Mr. Magids joined us in October 1996. Mr. Magids is a Certified Public Accountant and was with Arthur Andersen LLP from August 1986 until

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

September 1996, most recently as Director of Business Development.

Mr. Solimine has been our Controller since June 1994. He has served as Secretary for APS Financial since February 1995. From July 1989 to June 1994, Mr. Solimine served as our Manager of Accounting.

There are no family relationships, as defined, between any of our executive officers, and there is no arrangement or understanding between any of our executive officers and any other person pursuant to which he or she was selected as an officer. Each of our executive officers was elected by our board of directors to hold office until the next annual election of officers and until

8

his or her successor is elected and qualified or until his or her earlier resignation or removal. Our board of directors elects our officers in conjunction with each annual meeting of our shareholders.

### AVAILABLE INFORMATION

We file annual, quarterly, and current reports, proxy statements, and other documents with the SEC under the Securities Exchange Act of 1934 (the "Exchange Act"). You may read and copy any materials that we file with the SEC at the SEC's public reference room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the public reference room by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains a website that contains these SEC filings. You can obtain these filings at the SEC's website at <http://www.sec.gov>.

We also make available free of charge on or through our website (<http://www.amph.com>) our Annual Report on Form 10-KSB, Quarterly Reports on Form 10-QSB, Current Reports on Form 8-K, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

### ITEM 2. DESCRIPTION OF PROPERTY

We lease approximately 23,000 square feet of condominium space from Prime Medical in an office project at 1301 Capital of Texas Hwy., Suite C-300, Austin, Texas as our principal executive offices.

We also lease office space for our financial services subsidiary at 2550 Gray Falls Dr, Suite 350, Houston, Texas, and 7981 168th Ave, N.E. Suite 108, Redmond, Washington.

We also lease office space for our insurance services subsidiary at 5401 North Central Expressway, Suite 316, LB #B4, Dallas, Texas.

### ITEM 3. LEGAL PROCEEDINGS

We are involved in various claims and legal actions that have arisen in the ordinary course of our business. We believe that any liabilities arising from these actions will not have a material adverse effect on our financial condition or results of operations.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

# Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

None.

## PART II

### ITEM 5. MARKET FOR COMMON EQUITY RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

The following table represents the high and low prices of our common stock as reported by the Nasdaq Smallcap Market for years ended December 31, 2003 and 2002. On March 18, 2004, we had approximately 250 holders of record of our common stock.

	2003		2002	
	High	Low	High	Low
First Quarter	\$4.29	\$3.51	\$4.90	\$2.64
Second Quarter	\$5.49	\$3.58	\$4.67	\$3.49
Third Quarter	\$5.67	\$4.51	\$4.90	\$3.58
Fourth Quarter	\$10.77	\$5.10	\$4.57	\$3.51

We have not declared any cash dividends on our common stock during the last two years and have no present intention of paying any cash dividends in the foreseeable future. Our policy is to retain all earnings to provide funds for growth. Whether we decide to declare and pay dividends in the future will be based upon our earnings, financial condition, capital requirements and such other factors, as we may deem relevant.

The following table represents securities authorized for issuance under equity compensation plans, as described in Note 11 to the consolidated financial statements at December 31, 2003.

#### Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights.	Weighted-average exercise price of outstanding options, warrants and rights.
	(a)	(b)
Equity Compensation plans approved by security holders	815,000	\$4.49
Equity compensation		

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

plans not approved by security holders	none	none
-----		
Total	815,000	\$4.49
-----		

### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

#### Forward-Looking Statements

Our statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations, hopes, intentions or strategies regarding the future. You should not place undue reliance on forward-looking statements. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from those in the forward-looking statements. In addition to any risks and uncertainties specifically identified in the text surrounding the forward-looking statements, you should consult our reports on Forms 10-QSB and our other filings under the Securities Act of 1933 and the Securities Exchange Act of 1934, for factors that could cause our actual results to differ materially from those presented.

10

The forward-looking statements included herein are necessarily based on various assumptions and estimates and are inherently subject to various risks and uncertainties, including risks and uncertainties relating to the possible invalidity of the underlying assumptions and estimates and possible changes or developments in social, economic, business, industry, market, legal and regulatory circumstances and conditions and actions taken or omitted to be taken by third parties, including customers, suppliers, business partners and competitors and legislative, judicial and other governmental authorities and officials. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Any of these assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this report will prove to be accurate.

#### GENERAL

We provide (1) financial services, including brokerage and investment services to individuals and institutions, and (2) insurance services, including management and agency services to medical malpractice insurance companies.

Financial Services. We provide investment and investment advisory services to institutions and individuals throughout the United States through the following subsidiaries:

- o APS Financial. APS Financial is a fully licensed broker/dealer that provides brokerage and investment services primarily to institutional and high net worth individual clients. APS Financial also provides portfolio accounting, analysis, and other services to insurance

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

companies, banks and public funds. We recognize commissions revenue, and the related compensation expense, on a trade date basis.

- o Asset Management. Asset Management manages fixed income and equity assets for institutional and individual clients on a fee basis. We recognize fee revenues monthly based on the amount of funds under management.

Insurance Services. Through Insurance Services we provide management and agency services to medical malpractice insurance companies through the following subsidiary:

- o FMI. FMI provides management and administrative services to APIE, a regional insurance exchange that sells medical professional liability insurance only to its physician subscribers, who pay annual insurance premiums and surplus contributions to APIE. APIE is governed by a physician board of directors. Pursuant to a management agreement and the direction of this board, FMI manages and operates APIE, including performing policy issuance, claims investigation and settlement, and all other management and operational functions. As a management fee, FMI receives a percentage of APIE's earned premiums and a portion of APIE's profit, subject to a cap based on premium levels. We recognize revenues for the management fee portion based on a percentage of earned premium on a monthly basis, and we recognize revenues for the management fee portion based on profit sharing when it is reasonably certain the managed company will have an annual profit, generally in the fourth quarter. FMI's assets are not subject to APIE policyholder claims.

In addition, as of December 31, 2003, we have the following significant investments accounted for as available-for-sale securities: (1) we own approximately 728,000 shares of Prime Medical common stock, representing approximately 4% of its outstanding common stock, and (2) we own 385,000 shares of Financial Industries Corporation, representing approximately 4% of its outstanding common stock. We account for these investments as available-for-sale securities, which means they are reflected on our consolidated balance sheets at fair value, and fluctuations in fair value are recognized as unrealized gains or losses excluded from earnings and reported as a separate component of stockholders' equity, net income taxes.

11

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to, impairment of assets; bad debts; income taxes; and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and estimates affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. We periodically review the carrying value of our assets to determine if events and circumstances exist indicating that assets might be impaired. If facts and circumstances support this possibility of impairment, our management will prepare undiscounted and discounted cash flow projections, which require judgments that are both subjective and complex.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Management may also obtain independent valuations.

Our financial services revenues are composed primarily of commissions on securities trades and asset management fees. Revenues related to securities transactions are recognized on a trade date basis. Asset management fees are recognized as a percentage of assets under management during the period based upon the terms of agreements with the applicable customers.

Our insurance services revenues are primarily related to management fees based on the earned premiums of the managed company and include a profit sharing component, as defined in the management agreement, related to the managed company's annual earnings. Management fees are recorded, based upon the terms of the management agreement, in the period the related premiums are earned by the managed company. The managed company recognizes premiums as earned ratably over the terms of the related policy. The profit sharing component is recognized when it is reasonably certain the managed company will have an annual profit, and, typically, has been recognized during the fourth quarter.

When necessary, we record an allowance for doubtful accounts based on specifically identified amounts that we believe to be uncollectible. If our actual collections experience changes, revisions to our allowance may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers' credit could have a material affect on our results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. When necessary, we record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period the determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period the determination was made.

In 2002 we accounted for APS Consulting as a variable interest entity under the guidance of FIN 46 "Consolidation of Variable Interest Entities". We had not recognized the divestiture of APS Consulting and continued to consolidate the division as an entity in which we had a variable interest that would absorb the majority of the entity's operating losses should they have occurred. Accordingly, the assets and liabilities were included in our consolidated balance sheet as of December 31, 2002.

12

Effective November 1, 2003, APS Consulting paid off the negotiated remainder of the note due us, allowing us to cease accounting for them as a variable interest entity. Consequently, we have reclassified the 2002 income statement and balance sheets to reflect the disposition of APS Consulting as a discontinued operation.

### RESULTS OF OPERATIONS

#### OVERVIEW AND BUSINESS OUTLOOK

In 2003, we saw substantial improvement in operating income from both of our core business segments. As we look forward to 2004, there are both opportunities and impediments to continued growth.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

APS Financial, the broker/dealer division of our financial services segment, enjoyed a record year in both revenues and net profit in 2003. A combination of favorable bond market conditions, low personnel turnover, minimal loss of clients and minor fluctuations in non-variable operating expenses were the primary reasons for success. Matching or improving upon 2003 in 2004 will depend upon these same criteria repeating.

For commission revenue generation, bullish, unstable markets provide us with the most opportunity. Conversely, stable, bearish markets pose the greatest difficulty in generating income. Uncertainty in world, political and economic events can also be an obstacle to revenue generation. Investors may take a wait and see attitude should uncertainty exist. In a year of continued battle in the Middle East, threats of terrorism on the homeland and national political elections in the fall, there could be times when investors might conserve to cash.

Although we have been fortunate in retaining our key salespersons for many years, a loss of one or more key individuals and/or a loss of one or more key accounts is possible and could have a material adverse effect upon earnings.

The nature of the broker/dealer business and the current litigious legal environment in which we operate means that there is always the possibility of one or more lawsuits being brought against us. Claims against broker/dealers generally rise in periods of down markets and the more prolonged a downturn, generally the greater risk of litigation.

APS Insurance Services also enjoyed an excellent 2003, and looking forward to 2004, we believe could improve upon net earnings (before profit sharing) since we now own 100% of this subsidiary. In 2003, 20% of after-tax earnings of this segment was minority owned through September 30. Also, total surplus at APIE grew almost 22% in 2003 compared to 2002. If APIE's surplus continues to grow, this would continue to increase the financial strength of the company and its capacity to write new business.

The insurance segment is greatly affected by the profitability of the medical malpractice insurance company that we manage. Significant increases in claims brought against our insured doctors would negatively affect the profitability of APIE, and consequently, the amount of profit, if any, we would be able to share in. This risk has been reduced by lowering the limits of liability on the physicians we insure coupled with providing policies that cap our overall exposure. Further, there was passage of tort and insurance reform in the State of Texas in 2003. The new legislation capped non-economic damages and placed restrictions on mass litigation. As a result of tort reform, we anticipate that competitors will re-enter the State of Texas, which could result in pressure to lower rates or a reduction in the number of insurance policies written by APIE.

### 2003 COMPARED TO 2002

Revenues from operations increased \$7,372,000 (32%) compared to 2002. Our net income from continuing operations decreased \$384,000 (12%) to \$2,772,000 in 2003 from \$3,156,000 in 2002. Our net earnings decreased \$612,000 (18%) in 2003 to a total of \$2,799,000 compared to net earnings of 3,411,000 in 2002. Our diluted earnings per share decreased to \$1.14 in 2003 compared to \$1.45 in 2002. The reasons for these changes are described below.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Our financial services revenues increased \$6,000,000 (44%) in 2003 compared to 2002. The increase was due to strong commission revenues at APS Financial, the broker/dealer division of our financial services segment. APS Financial derives most of its revenue from trading in the fixed income market, both in investment and non-investment securities. While revenue from investment grade transactions has increased, revenue derived from the high yield market has been particularly strong, as that sector performed particularly well throughout 2003, as evidenced by various high yield indices rising as much as 29% compared to 2002. Also, we continue to have very low turnover in personnel, which gives us a better probability of maintaining our customer accounts.

Our financial services expense increased \$4,708,000 (40%) in 2003 compared to 2002. The primary reason for the current year increases is a \$3,808,000 (50%) increase in commission expense resulting from the increase in commission revenue at APS Financial mentioned above. In addition, net profits before management incentive costs increased at APS Financial by \$2,053,000 (79%) resulting in a \$762,000 (88%) increase in the current year formula driven management incentive costs. Payroll related benefit costs were up \$144,000 (25%) in 2003 as a result of a 27% increase in health insurance costs as well as higher payroll taxes as a result of much higher earnings by commissioned brokers. Partially offsetting these increases were relatively minor current year decreases in ticket charges, information services, depreciation and advertising costs.

### INSURANCE SERVICES

Our insurance services revenues from our premium-based insurance management segment, APS Insurance Services, increased \$1,372,000 (15%) in 2003 compared to 2002. The primary reason for the current year increase is that we recognized profit sharing with APIE this year for the first time since 1999. The total amount of profit sharing recognized in 2003 was \$722,000, all of which was recognized during the fourth quarter of 2003, after profit sharing goals were attained. As the certainty of profits at APIE cannot be fully known until an end-of-year actuarial analysis by independent actuaries, we cannot predict what, if any, profits will be available to us until this analysis is complete. Further contributing to the 2003 increase in revenues was a \$644,000 (10%) increase in management fees resulting from greater insurance premium volumes. The increase in 2003 premiums was primarily the result of rate increases throughout 2002 and 2003.

Insurance services expenses at the insurance management subsidiary increased \$775,000 (11%) in 2003 compared to 2002. The current year increase is primarily due to a \$309,000 (13%) increase in payroll expense, a \$81,000 (15%) increase in management incentive expense, a \$73,000 (32%) increase in employee benefits, and a \$130,000 (143%) increase in advertising. The current year increase in payroll is due primarily to the result of an industry salary analysis conducted in the latter half of 2002, which resulted in wages within certain departments increasing to competitive levels in order to retain personnel. In addition, two high-level management positions were added in 2003 to expand our business development and to meet growing financial reporting requirements. The increase in management incentive cost was the result of an increase in segment operating profits. As was the case with our investment services segment, employee benefit costs rose in the current year as a result of an increase in health insurance costs. Lastly, advertising costs were higher in 2003 as a result of re-branding efforts of the business.

### GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased \$117,000 (6%) in 2003 compared to 2002. Management incentive expense was \$37,000 (6%) higher in 2003 on substantially higher operating income in the current year. Legal fees were \$143,000 higher in 2003 primarily as a result of fees incurred in connection



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

with our investment in Financial Industries. Insurance expense was \$45,000 (90%) higher in 2003 on increased directors' and officers' liability insurance premiums. Audit fees were \$37,000 (40%) higher in 2003 as a result of new SEC

14

and accounting regulations implemented during the year. Partially offsetting these increases was a decrease in other professional fees (\$48,000) as outside consulting fees were incurred in 2002 to ascertain the value of a certain investment.

### GAIN ON SALE OF ASSETS

Gain on sale of assets primarily represents the recognition of deferred income. Approximately \$760,000 of the \$5,100,000 deferred gain on the sale of real estate to Prime Medical in 2001 was due to our ownership interest in Prime and is recognized upon the reduction of our ownership percentage in Prime Medical through the sale of its stock. In 2002, as a result of selling 1,570,000 shares of Prime Medical common stock, we recognized a proportionate percentage of the deferred gain, or about \$515,000. During 2003, we sold 24,000 shares of Prime Medical common stock and recognized a gain of \$8,000.

### GAIN ON SALE OF INVESTMENTS

Gain on the sale of investments decreased \$2,728,000 (96%) in 2003 compared to 2002. The current year decline was due to the sale of significantly less shares of Prime Medical common stock in 2003 compared to 2002. In 2002, we recorded gains on the sales of 1,570,000 shares compared to 24,000 shares sold in 2003. Gains resulting from sales of Prime common stock were \$64,000 and \$2,855,000 in 2003 and 2002, respectively. As a result of these sales, as of December 31, 2003, we own approximately 728,000 shares of Prime Medical amounting to an ownership percentage of approximately 4%. In addition to the sale of Prime Medical shares we sold a number of fixed income securities in 2003, which resulted in gains comprising the majority of the remaining income reported.

### AFFILIATES EARNINGS (LOSS)

Our equity in the earnings of Prime Medical was zero in 2003 as we no longer account for our investment in Prime Medical using the equity method of accounting, as was the case in the first quarter of 2002 when we recorded \$186,000 in equity earnings. As of March 19, 2002, we ceased accounting for our investment in Prime Medical using the equity method of accounting because (1) on January 1, 2002, Kenneth S. Shifrin, the Company's Chairman and CEO, stepped down from day-to-day operations as Executive Chairman of the Board of Prime Medical, but continues to serve as non-executive Chairman; and (2) from January to March 19, 2002, we sold 1,570,000 shares of Prime Medical reducing our ownership percentage to approximately 5%.

Our equity in earnings of Uncommon Care increased to \$260,000 in 2003 compared to a loss of \$230,000 in 2002. Because our total investment and advances to Uncommon Care has been reduced to zero we suspended recording equity losses, as required under the equity method. In 2002, we advanced them \$230,000 and recorded a loss for the full amount of the advance. In 2003, after informing management that no further advances would be made to the Company, we recorded equity in earnings of unconsolidated affiliates in the amount of \$260,000 related to cash received from Uncommon Care. We expect no further receipts of cash from Uncommon Care and consequently expect to record no additional income in the future.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

### INTEREST INCOME

Our interest income decreased \$68,000 (18%) in 2003 compared to 2002 primarily as a result of a higher balance of interest-bearing securities held in 2002. In June 2003, we liquidated approximately \$4.0 million in interest-bearing securities in order to secure the funds required to invest in 385,000 shares of Financial Industries common stock.

15

### OTHER LOSS

Our other loss decreased \$120,000 (76%) in 2003 compared to 2002. The primary reason for the current year decrease in loss was the result of management fees received in 2003 from our former consulting division, which totaled \$98,000.

### MINORITY INTERESTS

Minority interests represents the combination of two outside interests in subsidiaries of the Company: a twenty percent interest in Insurance Services owned by FPIC Insurance Group, Inc. and a three percent interest in APS Asset Management, a subsidiary of the financial services subsidiary of the Company (APS Investment Services), owned by key individuals within APS Asset Management. Minority interests decreased in the current year due to the repurchase of the 20% minority interest in Insurance Services from the minority interest holder, FPIC Insurance Group effective October 1, 2003. Consequently, only nine months of minority interest was recorded in 2003 compared to a full year in 2002.

### DISCONTINUED OPERATIONS

Effective November 1, 2003 APS Consulting paid off the negotiated remaining amount of the note payable to us. Even though we had sold this segment to APS Consulting's management exactly one year earlier, we continued to consolidate their revenues, expenses and balance sheet items as we were dependent upon future successful operations of the division to collect our proceeds from the disposal and we did not transfer risk of loss to discontinue reporting them on our consolidated financial statements. With the payoff of the note we recognized the divestiture and now report APS Consulting as a discontinued operation. Accordingly, 2002 has been reclassified to remove revenues and expenses from our consolidated statements of operations and after-tax results of this former division are now recorded as income from discontinued operations in 2002. For 2003, only the after-tax gain on disposal of the segment is recorded as earnings from APS Consulting.

### LIQUIDITY AND CAPITAL RESOURCES

#### WORKING CAPITAL

Our net working capital was \$8,537,000 and \$5,799,000 at December 31, 2003 and 2002, respectively. The increase in the current year was due primarily to the following factors: (1) the sale of our stock in Uncommon Care, Inc. allowed us to write off for tax purposes a total loss in the investment of \$6.7 million, resulting in an increase in our federal income tax receivable of approximately \$2.3 million in 2003; (2) management fees receivable from APIE were much higher in 2003 as a result of profit sharing of approximately \$722,000 compared to zero in 2002. This amount was received from APIE in March, 2004; and (3) cash received from operations. Partially offsetting these increases to working capital in 2003 was an increase in accrued compensation and other current accrued liabilities totaling approximately \$1.2 million. The primary reason for

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

this increase was higher incentive compensation accruals resulting from formula-driven, earnings based calculations arising due to much higher earnings from operations. Historically, we have maintained a strong working capital position and, as a result, we have been able to satisfy our operational and capital expenditure requirements with cash generated from our operating and investing activities. These same sources of funds have also allowed us to pursue investment and expansion opportunities consistent with our growth plans. Although there can be no assurance our operating activities will provide positive cash flow in 2004, we are optimistic that our working capital requirements will be met for the foreseeable future for the following reasons: (1) our current cash position is very strong, with a balance of approximately \$9.0 million comprising 34 percent of our total assets; (2) our investments in available-for-sale equity and fixed income securities could provide an additional \$9.6 million should the need arise, although at December 31, 2003, a liquidation of these investments would have caused a loss of \$371,000 to be realized; (3) we expect federal income tax refunds during the first half of 2003 to be around \$700,000 with approximate additional refunds during the second half of 2003 totaling \$1 million; and (4) we established a line of credit in November 2003 that is described below.

16

### LINE OF CREDIT

During November 2003, we established a \$3.0 million line of credit with PlainsCapital Bank. The loan calls for interest payments only to be made on any amount drawn until April 15, 2004, when the entire amount of the note, principal and interest then remaining unpaid, shall be due and payable. We expect to renew this line of credit for a period of one year following the April 15, 2004 maturity date. At December 31, 2003, there were no draws taken against this line of credit. We are in compliance with the covenants of the loan agreement, including requirements for a minimum of \$5.0 million of unencumbered liquidity and a minimum 2 to 1 debt to worth ratio, and expect to remain in compliance at the time of renewal.

### CAPITAL EXPENDITURES

Our capital expenditures for equipment were \$223,000 and \$139,000 in 2003 and 2002, respectively. Our capital expenditures were higher in 2003 due to purchases necessary to upgrade our network server hardware and software as well as to leasehold improvements at our corporate office. We expect capital expenditures in 2004 to be approximately \$325,000, including \$200,000 in improvements to our reporting software. Our 2004 capital expenditure budget is expected to be funded through cash on hand.

### COMMITMENTS

There were no participation agreements or purchase commitments at December 31, 2003. We have committed cash outflow related to operating lease arrangements with a term exceeding one year and other contractual obligations at December 31, 2003 as follows (in thousands):

	Payment Due				
Contractual Cash Obligation	2004	2005	2006	2007	2008
-----	-----	-----	-----	-----	-----

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Operating Leases	\$964	\$810	\$510	\$8	\$0
------------------	-------	-------	-------	-----	-----

### MARGIN LOANS

We extend credit to our customers, which is financed through our clearing organization, SWS Securities, Inc. or SWS, to help facilitate customer securities transactions. This credit, which earns interest income, is known as "margin lending". In margin transactions, the client pays a portion of the purchase price of securities, and we make a loan (financed by our clearing organization) to the client for the balance, collateralized by the securities purchased or by other securities owned by the client.

In permitting clients to purchase on margin, we are subject to the risk of a market decline, which could reduce the value of our collateral below the client's indebtedness. Agreements with margin account clients permit our clearing organization to liquidate our clients' securities with or without prior notice in the event of an insufficient amount of margin collateral. Despite those agreements, our clearing organization may be unable to liquidate clients' securities for various reasons including the fact that the pledged securities may not be actively traded, there is an undue concentration of certain securities pledged, or a trading halt is issued with regard to pledged securities. As of December 31, 2003, the total of all customer securities pledges on debit balances held in margin accounts was approximately \$3.3 million.

We are also exposed should SWS be unable to fulfill its obligations for securities transactions.

17

Our ability to make scheduled payments or to fund planned capital expenditures will depend on our future performance, which, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. There can be no assurance that our business will generate cash flow from operations or that we will realize anticipated revenue growth and operating improvements sufficient to make scheduled payments and fund planned future capital expenditures.

### INFLATION

Our operations are not significantly affected by inflation because, having no manufacturing operations, we are not required to make large investments in fixed assets. However, the rate of inflation will affect certain of our expenses, such as employee compensation and benefits.

### IMPACT OF NEW ACCOUNTING STANDARDS

As more fully described in Note 1 of Notes to Consolidated Financial Statements, on January 1, 2004, we are required to adopt several new accounting standards. For a discussion of the impact of those new accounting standards upon us, see Note 1 (n).

### QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We have exposure to changes in interest rates and the market values of our investments but have no material exposure to fluctuations in foreign currency.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

### INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relates to both our investment portfolio and our revenues generated through commissions at our financial services segment. All of our marketable fixed income securities are designated as available-for-sale and, accordingly, are presented at fair value on our balance sheets. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates.

Changes in interest rates could have an impact at our broker/dealer subsidiary, APS Financial. The general level of interest rates may trend higher or lower in 2004, and this move may impact our level of business in different fixed-income sectors. If a generally improving economy is the impetus behind higher rates, then while our investment grade business may drop off, our high yield business might improve with improving credit conditions. A volatile interest rate environment in 2004 could also impact our business as this type of market condition can lead to investor uncertainty and their corresponding willingness to commit funds.

As we currently have no debt and don't anticipate the need to take on any debt in 2004, interest rate changes will have no impact on our financial position as it pertains to interest expense.

### INVESTMENT RISK

As of December 31, 2003, our recorded basis in debt and equity securities was approximately \$10.2 million. We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that such declines in the fair value of such assets below our accounting basis are other-than-temporary. During 2003 and 2002, we recorded no impairment losses. The fair values of our investments are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly-traded equity securities we held at December 31, 2003 of \$9.6 million, an assumed 15%, 30%, and 50% adverse change to market prices of these securities would result in a corresponding decline in total fair value of approximately \$1.4 million, \$2.9

18

million and \$4.8 million, respectively. As these investments are held as available-for-sale, these declines would be treated as unrealized holding losses on our balance sheet unless it was determined the market declines were other-than-temporary, in which case these declines would be recognized in the period the determination was made.

### ITEM 7. FINANCIAL STATEMENTS

The information required by this item is contained in Appendix A attached hereto.

### ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

### ITEM 8A. CONTROLS AND PROCEDURES

At December 31, 2003, under the supervision and with the participation of

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

our management, including our Chief Executive Officer (our principal executive officer) and our Chief Financial Officer (our principal financial officer), we evaluated the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that, as of December 31, 2003, our disclosure controls and procedures are effective.

There have been no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, such internal control over financial reporting.

### PART III

#### ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item will be contained in our definitive proxy statement to be filed in connection with our 2004 annual meeting of shareholders, except for the information regarding our executive officers, which is presented in Part I. The information required by this item contained in our definitive proxy statement is incorporated herein by reference.

#### ITEM 10. EXECUTIVE COMPENSATION

The information required by this item will be contained in our definitive proxy statement to be filed in connection with our 2004 annual meeting of shareholders, which information is incorporated herein by reference.

#### ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item will be contained in our definitive proxy statement to be filed in connection with our 2004 annual meeting of shareholders, which information is incorporated herein by reference.

#### ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item will be contained in our definitive proxy statement to be filed in connection with our 2004 annual meeting of shareholders, which information is incorporated herein by reference.

19

### PART IV

#### ITEM 13. EXHIBITS, LISTS, AND REPORTS ON FORM 8-K

(a) 1. Financial Statements  
The information required by this item is contained in Appendix A attached hereto.

(b) Reports on Form 8-K for the quarter ended December 31, 2002

(none)

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

- (c) Exhibits (1)
- 3.1 Restated Articles of Incorporation of the Company, as amended. (5)
- 3.2 Amended and Restated Bylaws of the Company. (5)
- 4.1 Specimen of Common Stock Certificate. (2)
- 4.2 Rights Agreement, dated as of August 15, 2000, between American Physicians Service Group, Inc. and American Stock Transfer & Trust Company, which includes the form of Statement of Resolutions setting forth the terms of the Junior Participating Preferred Stock, Series A, the form of Rights Certificate as Exhibit B and the Summary of Rights to Purchase Preferred Shares as Exhibit C. (10)
- \*10.1 1995 Incentive and Non-Qualified Stock Option Plan of American Physicians Service Group, Inc. (6)
- \*10.2 Form of Stock Option Agreement (ISO). (6)
- \*10.3 Form of Stock Option Agreement (Non-Qualified). (6)
- 10.4 Management Agreement of Attorney-in-Fact, dated August 13, 1975, between FMI and American Physicians Insurance Exchange. (2)
- \*10.5 Profit Sharing Plan and Trust, effective December 1, 1984, of the Company. (3)
- \*10.6 First Amendment to 1995 Incentive and Non-Qualified Stock Option Plan of American Physicians Service Group, Inc. Dated December 10, 1997.
- \*10.7 First Amendment to 1995 Non-Employee Director Stock Option Plan of American Physicians Service Group, Inc. Dated December 10, 1997. (8)
- 10.8 Contribution and Stock Purchase Agreement dated January 1, 1998 between the Company, Additional Purchasers, Barton Acquisition, Inc., Barton House, Ltd., Barton House at Oakwell Farms, Ltd., Uncommon Care, Inc., George R. Bouchard, John Trevey and Uncommon Partners, Ltd. (9)
- 10.9 Stock Transfer Restriction and Shareholders Agreement dated January 1, 1998 between the Company, Additional Purchasers, Barton Acquisition, Inc., Barton House, Ltd., Barton House at Oakwell Farms, Ltd., Uncommon Care, Inc., George R. Bouchard, John Trevey, and Uncommon Partners, Ltd. (9)
- 10.10 Loan Agreement dated January 1, 1998 between the Company and Barton Acquisition, Inc. (9)
- 10.11 Promissory Note (Line of Credit) dated January 1, 1998 between the Company and Barton Acquisition, Inc. in the amount of \$2,400,000. (9)
- 10.12 Security Agreement dated January 1, 1998 between the Company and Barton Acquisition, Inc. (9)

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

- 10.13 Participation Agreement dated March 16, 1998 between the Company and Additional Purchasers referred to as Participants. (9)
- 10.14 Loan Agreement dated June 16, 1999 between APS Consulting, Inc. and APSC, Inc. (10)
- 10.15 Promissory Note dated June 16, 1999 between APS Consulting, Inc. and APSC, Inc. (10)
- 10.16 Security Agreement dated June 16, 1999 between APS Consulting, Inc. and APSC, Inc. (10)
- 10.17 Subordination Agreement dated June 16, 1999 between the Company and APSC, Inc. (10)
- 10.18 Convertible Promissory Note dated April 27, 1999 between the Company and Uncommon Care, Inc. (10)
- 10.19 Replacement Convertible Promissory Note dated September 30, 1999 between the Company and Uncommon Care, Inc. (10)
- 10.20 Liquidity Promissory Note dated September 30, 1999 between the Company and Uncommon Care, Inc. (10)
- 10.21 Replacement Liquidity Note dated October 15, 1999 between the Company and Uncommon Care, Inc. (10)
- 10.22 Management Services Agreement dated January 1, 2000 between the Company and APS Consulting. (11)
- 10.23 Tax Sharing Agreement dated January 1, 2000 between the Company and APS Consulting. (11)
- 10.24 \$1.25 million Promissory Note dated June 1, 2000 between the Company and Uncommon Care, Inc. (11)
- 10.25 \$1.20 million Promissory Note dated June 1, 2000 between the Company and Uncommon Care, Inc. (11)
- 10.26 Agreement dated November 22, 2002 transferring and assigning all capital stock of Eco-Systems from the Company to the purchaser. (12)
- \*10.27 Amended 1995 Incentive and Non-Qualified Stock Option Plan (12)
- \*10.28 Executive Employment Agreement between the Company and Kenneth S. Shifrin. (12)
- \*10.29 Consulting Agreement between the Company and William A. Searles (12)
- \*10.30 Executive Employment Agreement between the Company and William H. Hayes. (12)
- 10.31 Stock Purchase Agreement dated October 31, 2003 between the Company and FPIC Insurance Group, Inc. (13)
- 10.32 Revolving Promissory Note dated November 12, 2003 between the Company and PlainsCapital Bank. (13)
- 10.33 Loan Agreement dated November 12, 2003 between the Company and PlainsCapital Bank. (13)
- 21.1 List of subsidiaries of the Company. (13)



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

- 23.1 Independent Auditors Consent of BDO Seidman, LLP. (13)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (13)
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (13)
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (13)
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (13)

21

(\* ) Executive Compensation plans and arrangements.

- 
- (1) The Company is subject to the informational requirements of the Securities Exchange Act of 1934, as amended, and, in accordance therewith, files reports, proxy statements and other information with the Commission. Reports, proxy statements and other information filed by the Company can be inspected and copied at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549, and at the Commission's Regional Offices at Seven World Trade Center, 13th Floor, New York, New York 10048 and CitiCorp Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661-2511. Copies of such material can be obtained by mail from the Public Reference Section of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates. Such reports, proxy statements and other information concerning the Company are also available for inspection at the offices of The NASDAQ National Market, Reports Section, and 1735 K STREET, N.W., WASHINGTON, D.C. 20006. The Commission maintains a Web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission at <http://www.sec.gov> and makes available the same documents through Disclosure, Inc. at 800-638-8241.
  - (2) Filed as an Exhibit to the Registration Statement on Form S-1, Registration No. 2-85321, of the Company, and incorporated herein by reference.
  - (3) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 1984 and incorporated herein by reference.
  - (4) Filed as an Exhibit to the Current Report on Form 8-K of the Company dated September 5, 1989 and incorporated herein by reference.
  - (5) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 1990 and incorporated herein by reference.
  - (6) Filed as an Exhibit to the Annual Report on Form 10-KSB of the Company for the year ended December 31, 1995 and incorporated herein by reference.

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

- (7) Filed as an Exhibit to the Annual Report on Form 10-KSB of the Company for the year ended December 31, 1996 and incorporated herein by reference.
- (8) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 1997 and incorporated herein by reference.
- (9) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 1998 and incorporated herein by reference.
- (10) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 1999 and incorporated herein by reference.
- (11) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 2000 and incorporated herein by reference.
- (12) Filed as an Exhibit to the Annual Report on Form 10-K of the Company for the year ended December 31, 2002 and incorporated herein by reference.
- (13) Filed herewith

22

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item will be contained in our definitive proxy statement to be filed in connection with our 2004 annual meeting of shareholders, which information is incorporated herein by reference.

SIGNATURES

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

AMERICAN PHYSICIANS SERVICE GROUP, INC.

By: /s/ Kenneth S. Shifrin

-----  
Kenneth S. Shifrin, Chairman of the Board and Chief Executive Officer

Date: March 30, 2004

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

By: /s/ Kenneth S. Shifrin

-----  
Kenneth S. Shifrin

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Chairman of the Board and  
Chief Executive Officer  
(Principal Executive Officer)

Date: March 30, 2004

By: /s/ W. H. Hayes  
-----

W. H. Hayes  
Senior Vice President - Finance, Secretary  
and Chief Financial Officer  
(Principal Financial Officer)

Date: March 30, 2004

23

By: /s/ Thomas R. Solimine  
-----

Thomas R. Solimine  
Controller  
(Principal Accounting Officer)

Date: March 30, 2004

By: /s/ Jackie Majors

Jackie Majors, Director

Date: March 30, 2004

By: /s/ Robert L. Myer  
-----

Robert L. Myer, Director

Date: March 30, 2004

By: /s/ William A. Searles  
-----

William A. Searles, Director

Date: March 30, 2004

# Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

By: /s/ Cheryl Williams

Cheryl Williams, Director

Date: March 30, 2004

24

## APPENDIX A

### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Independent Auditors' Report	A-2
Consolidated Financial Statements	
Consolidated Statements of Operations for the Years ended December 31, 2003 and 2002	A-3
Consolidated Balance Sheets as of December 31, 2003 and December 31, 2002	A-5
Consolidated Statements of Cash Flows for the Years ended December 31, 2003 and 2002	A-7
Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss) for the Years ended December 31, 2003 and 2002	A-8
Notes to Consolidated Financial Statements	A-9

A-1

Independent Auditors' Report

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

The Board of Directors and Shareholders

American Physicians Service Group, Inc.

Austin, Texas

We have audited the accompanying consolidated balance sheets of American Physicians Service Group, Inc. (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for each of the two years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American Physicians Service Group, Inc. at December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

Houston, Texas

March 21, 2004

BDO Seidman

-----  
/s/ BDO Seidman, LLP

A-2

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

Item 1 - Financial Statements

Revenues:

Year End

-----  
2003  
-----

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Financial services	\$19,623
Insurance services	10,826
	-----
Total revenues	30,449
Expenses:	
Financial services	16,584
Insurance services	7,841
General and administrative	2,069
Gain on sale of assets	(8)
	-----
Total expenses	26,486
	-----
Operating income	3,963
Gain on sale of investments (Note 5)	127
	-----
Income from continuing operations before interest, income taxes, minority interests and equity in loss of unconsolidated affiliates	4,090
Interest income	304
Other loss	(38)
Interest expense	7
Income tax expense (Note 10)	1,640
Minority interests	197
Equity in earnings (loss) of unconsolidated affiliates (Note 15)	260
	-----
Income from continuing operations	2,772
Discontinued operations: (Note 13)	
Income from discontinued operations, net of income tax expense of \$132 in 2002	--
Gain on disposal of discontinued segment net of income tax expense of \$14 in 2003	27
	-----
Net income	\$ 2,799
	=====

See accompanying summary of accounting policies and notes to financial statements.

A-3

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS, continued

(In thousands, except per share amounts)

Year Ended December 31,	
-----	
2003	2002

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Net income per common share		
Basic:		
Income from continuing operations	\$ 1.26	\$ 1.42
Discontinued operations	0.01	0.11
Net income	\$ 1.27	\$ 1.53
Diluted:		
Income from continuing operations	\$ 1.13	\$ 1.35
Discontinued operations	0.01	0.11
Net income	\$ 1.14	\$ 1.45
Basic weighted average shares outstanding	2,207	2,227
Diluted weighted average shares outstanding	2,449	2,345

See accompanying summary of accounting policies and notes to financial statements.

A-4

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED BALANCE SHEETS

(In thousands)

	De
	2003
ASSETS	
Current Assets:	
Cash and cash equivalents	\$8,989
Trading account securities	67
Notes receivable (Note 3)	16
Management fees and other receivables (Note 2)	1,079
Deposit with clearing organization	500
Receivable from clearing organization	67
Investment in available-for-sale fixed income securities	--
Net deferred income taxes (Note 10)	532
Income tax receivable	1,678
Prepaid expenses and other current assets	565

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Total current assets	13,493
Notes receivable, less current portion (Note 3)	436
Property and equipment, net (Note 6)	378
Investment in available-for-sale equity securities (Note 5)	8,729
Investment in available for sale fixed income securities (Note 5)	897
Goodwill (Note 15)	1,257
Net deferred income taxes (Note 10)	--
Other assets	448
Assets of discontinued operations	--
	-----
Total Assets	\$25,638
	=====

See accompanying summary of accounting policies and notes to financial statements.

A-5

### AMERICAN PHYSICIANS SERVICE GROUP, INC. CONSOLIDATED BALANCE SHEETS, continued

(In thousands, except share data)

	2003
	-----
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable - trade	2
Payable to clearing broker	1
Accrued incentive compensation	1
Accrued expenses and other liabilities (Note 7)	1
Deferred gain (Note 9)	1
Deferred income tax liability (Note 10)	1
	-----
Total current liabilities	4
Payable under loan participation agreements	1
Deferred income tax liability (Note 10)	1
Deferred gain (Note 9)	1
Liabilities of discontinued operations	1
	-----
Total liabilities	6
Minority interests	
Shareholders' Equity:	
Preferred stock, \$1.00 par value, 1,000,000	1



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

shares authorized, none issued or outstanding  
 Common stock, \$0.10 par value, shares authorized 20,000,000;  
 2,454,667 and 2,133,843 issued and outstanding at 12/31/03  
 and 12/31/02, respectively  
 Additional paid-in capital  
 Retained earnings  
 Accumulated other comprehensive income (loss), net of taxes

	6
	12
Total shareholders' equity	19
	-----
Total Liabilities and Shareholders' Equity	\$25
	=====

See accompanying summary of accounting policies and notes to financial statements.

A-6

### AMERICAN PHYSICIANS SERVICE GROUP, INC. CONSOLIDATED STATEMENTS OF CASHFLOWS

(In thousands)

	Year
	2003
	-----
Cash flows from operating activities:	
Net Income	\$ 2,799
Adjustments to reconcile net income to cash used in operating activities:	
Depreciation and amortization	206
Forgiveness of debt and other	164
Minority interest in consolidated earnings	197
Undistributed (gain) loss of affiliates	(260)
Gain on sale of assets	(469)
Gain on sale of investment	(127)
Provision for bad debt	(58)
Changes in operating assets and liabilities:	
Trade receivables	(325)
Trading account securities	66
Income tax receivable	(996)
Deferred income tax	2,511
Receivable from clearing organization	--
Management fees & other receivables	(316)
Prepaid expenses & other assets	207
Deferred income	(122)
Trade accounts payable	(138)
Accrued expenses & other liabilities	1,266
	-----
Net cash received in operating activities	4,605
Cash flows from investing activities:	
Capital expenditures	(319)

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Proceeds from the sale of available-for-sale equity and fixed income securities	4,118
Purchase of available-for-sale equity securities	(5,697)
Purchase of minority interest	(2,050)
Receipts from (advances to) affiliate	175
Funds loaned to others	(155)
Collection of notes receivable	745
Net cash (used in) provided by investing activities	(3,183)
Cash flows from financing activities:	
Payment of long term debt	--
Exercise of stock options	1,351
Purchase and cancellation of treasury stock	(285)
Distribution to minority interest	(190)
Net cash received from (used in) financing activities	876
Net change in cash and cash equivalents	\$ 2,298
Cash and cash equivalents at beginning of period	6,691
Cash and cash equivalents at end of period	\$ 8,989

See accompanying summary of accounting policies and notes to financial statements.

A-7

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

(In thousands)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income	Accumul Othe Comprehe Income (
Balance December 31, 2001	\$ 275	\$ 5,539	\$ 8,310		\$ (39
Comprehensive income:					
Net income	--	--	3,411	3,411	--
Other comprehensive income:					
Unrealized gain on securities, net of taxes of \$1,843	--	--	--	1,869	1,86
Comprehensive income	--	--	--	5,280	--
Treasury stock purchase	--	--	--	--	--
Retired treasury stock	(62)	--	(2,206)	--	--
Stock options exercised	--	45	--	--	--
Stock options expensed	--	--	--	--	--
Balance December 31, 2002	\$213	\$5,584	\$9,515	\$ --	\$1,83

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Comprehensive income:					
Net income	--	--	2,799	2,799	--
Other comprehensive income:					
Unrealized loss on securities, net of taxes of \$1,134	--	--	--	(2,201)	(2,201)
Comprehensive income	--	--	--	598	--
Treasury stock purchases	--	--	--	--	--
Tax benefit from exercise of stock options	--	300	--	--	--
Retired treasury stock	(6)	(279)	--	--	--
Stock options exercised	38	1,313	--	--	--
Balance December 31, 2003	\$245	\$6,918	\$12,314	\$ --	(\$37)

See accompanying summary of accounting policies and notes to financial statements.

A-8

AMERICAN PHYSICIANS SERVICE GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2003 and 2002

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) GENERAL

We, through our subsidiaries, provide financial services that include brokerage and asset management services to individuals and institutions, and insurance services that consist of management services for a malpractice insurance company. The financial services business has clients nationally. Insurance management is a service provided primarily in Texas, but is available to clients nationally. During the two years presented in the financial statements, financial services generated 64% and 59% of total revenues and insurance services generated 36% and 41% in 2003 and 2002, respectively.

(b) MANAGEMENT'S ESTIMATES AND ASSUMPTIONS

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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. Actual results could differ from those estimates.

(c) PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include our accounts and the accounts of our subsidiary companies more than 50% owned. Investments in affiliated companies and other entities, in which our investment is less than 50% of the common shares outstanding and where we exert significant influence over operating and financial policies, are accounted for using the equity method. Investments in other entities in which our investment is less than 20%, and in which we do not have the ability to exercise significant influence over operating and financial policies, are accounted for using the cost method.

We own 100% of our insurance services segment after repurchasing the 20% formerly owned by Florida Physicians Insurance Group, Inc. ("FPIC"), on September 30, 2003 (see Note 14). Before this date, we recorded minority interest to reflect the 20% of its net income or loss attributable to the minority shareholder.

All significant intercompany transactions and balances have been eliminated from the accompanying consolidated financial statements.

(d) REVENUE RECOGNITION

Our investment services revenues related to securities transactions are recognized on a trade date basis. Asset management revenues are recognized monthly based on the amount of funds under management.

Our insurance services revenues related to management fees are recognized monthly as a percentage of the earned insurance premiums of the managed company. The profit sharing component of the management services agreement is recognized when it is reasonably certain that the managed company will have an annual profit, generally in the fourth quarter of each year.

A-9

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

(e) MARKETABLE SECURITIES

Our investments in debt and equity securities are classified in three categories and accounted for as follows:

Classification	Accounting
-----	-----
Held-to-maturity	Amortized cost
Trading securities	Fair value, unrealized gains and losses included in earnings
Available-for-sale	Fair value, unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of applicable income taxes. Realized gains and losses are included in earnings.

We have included our marketable securities, held as inventory at our broker/dealer, in the trading securities category. We have included investments in marketable securities not held as inventory at our broker/dealer in the available-for-sale securities category.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

### (f) PROPERTY AND EQUIPMENT

Property and equipment is stated at cost net of accumulated depreciation. Property and equipment is depreciated using the straight-line method over the estimated useful lives of the respective assets (3 to 5 years). Leasehold improvements are depreciated using the straight-line method over the life of the lease or their expected useful life, whichever is shorter.

### (g) LONG-LIVED ASSETS

Long-lived assets, principally property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, a loss is recognized if there is a difference between the fair value and carrying value of the asset. Management's analysis of our long-lived assets at December 31, 2003 and 2002 indicated that there was no impairment to these assets' carrying values.

Investments are evaluated for impairment in the event of a material change in the underlying business. Such evaluation takes into consideration our intent and time frame to hold or to dispose of the investment and takes into consideration available information, including recent transactions in the stock, expected changes in the operations or cash flows of the investee, or a combination of these and other factors. Management's evaluation of our investments resulted in no impairment to these investments.

A-10

## (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

### (h) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the excess of cost over the fair value of net assets acquired. We account for goodwill and other intangible assets according to the Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets", which addresses financial accounting and reporting matters for business combinations. Under the provision of SFAS No. 142, goodwill is not amortized, but is evaluated annually for impairment or more frequently if circumstances indicate that impairment may exist. The goodwill valuation is largely influenced by projected future cash flows and, therefore, is significantly impacted by estimates and judgments.

We amortize other identifiable intangible assets on a straight-line basis over the periods expected to be benefited. The components of these other intangible assets, recorded in Other Assets in the accompanying consolidated balance sheets, consist primarily of a non-compete agreement.

### (i) ALLOWANCE FOR DOUBTFUL ACCOUNTS

When applicable, we record an allowance for doubtful accounts based on specifically identified amounts that we believe to be uncollectible. If our actual collections experience changes, revisions to our allowance may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers' credit could have a

material affect on our results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.

(j) INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not.

(k) CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash and highly liquid investments with a maturity date at purchase of 90 days or less. We deposit our cash and cash equivalents with high credit quality institutions. Periodically such balances may exceed applicable FDIC insurance limits. Management has assessed the financial condition of these institutions and believes the possibility of credit loss is minimal.

(l) NOTES RECEIVABLE

Notes receivable are recorded at cost, less allowances for doubtful accounts when deemed necessary. Management, considering current information and events regarding the borrowers ability to repay their obligations, considers a note to be impaired when it is probable that we will be unable to collect all

A-11

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

amounts due according to the contractual terms of the note agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the note's effective interest rate. Impairment losses are included in the allowance for doubtful accounts through a charge to bad debt expense. The present value of the impaired loan will change with the passage of time and may change because of revised estimates of cash flows or timing of cash flows. Such value changes are reported as bad debt expense in the same manner in which impairment initially was recognized. No interest income is accrued on impaired loans. Cash receipts on impaired loans are recorded as reductions of the principal amount.

(m) STOCK-BASED COMPENSATION

We have adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("Statement 123"), but apply Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, in accounting

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

for our stock option plans. In 2003 we purchased 15,000 unexpired options from a grantee and in 2002 we purchased 89,000 unexpired options from four grantees. These purchases in effect modified the terms of the options and, accordingly, we recognized \$34,000 and \$156,000 of compensation expense in 2003 and 2002 respectively. No other compensation expense from stock-based compensation awards was recognized in 2003 and 2002. If we had elected to recognize compensation expense for options granted based on their fair values at the grant dates, consistent with Statement 123, net income and earnings per share would have changed to the pro forma amounts indicated below:

	Year Ended December 31,	
	2003	2002
Net income, as reported	\$ 2,799,000	\$3,411,000
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(241,000)	(222,000)
Pro forma net income	\$ 2,558,000	\$3,189,000
Net income per share		
Basic - as reported	\$1.27	\$1.53
Basic - pro forma	\$1.16	\$1.43
Diluted - as reported	\$1.14	\$1.45
Diluted - pro forma	\$1.04	\$1.36

### (n) RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No.13, and Technical Corrections. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback

A-12

### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of the Statement related to the rescission of Statement No. 4 is applied in fiscal years beginning after May 15, 2002. Earlier application of these provisions is encouraged. The provisions of the Statement related to Statement No. 13 were effective for transactions occurring after May 15, 2002, with early application encouraged. We adopted No. 145 on January 1, 2003. The adoption of this statement did not have a material effect on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. This Statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements. We have not elected to adopt the provisions of this Statement.

In May 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. We do not engage in hedging activities and, accordingly, the adoption of this Statement did not have an impact on our financial statements.

In May 2003, the FASB issued SFAS No. 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". SFAS No. 150 establishes standards for how an issuer measures certain financial instruments with characteristics of both liabilities and equity and requires that an issuer classify a financial instrument within its scope as a liability (or Asset in some circumstances). SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003 and otherwise was effective and adopted by the Company on July 1, 2003. As we have no such instruments, the adoption of the Statement did not have an impact on our financial condition or results of operations.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51. This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to a variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. We voluntarily elected early adoption of Interpretation No. 46. The effect of the application of this Interpretation is described in Note 13 to these consolidated financial statements.

### (o) RECLASSIFICATION

Certain reclassifications have been made to amounts presented in 2002 to be consistent with the 2003 presentation.

A-13

### (2) MANAGEMENT FEES AND OTHER RECEIVABLES

Management fees and other receivables consist of the following:

	December 31,	
	2003	2002
Management fees receivable	\$ 739,000	\$ 382,000
Accrued interest receivable	22,000	91,000



Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Other receivables	318,000	341,000
	-----	-----
	\$1,079,000	\$ 814,000
	=====	=====

We earn management fees by providing management services to American Physicians Insurance Exchange ("APIE") under the direction of APIE's Board of Directors. APIE is a reciprocal insurance exchange, which is wholly-owned by its subscriber physicians. Subject to the direction of APIE's Board, and subject to a management services agreement, FMI sells and issues medical insurance policies, investigates, settles and defends claims, and otherwise manages APIE's affairs. The management agreement with FMI obligates APIE to pay management fees to FMI based on a percentage of APIE's earned premiums before payment of reinsurance premiums. In addition, the management agreement provides that any profits, as defined, of APIE will be shared equally with FMI so long as the total payment (fees and profit sharing) does not exceed a cap based on premium levels. Management fees attributable to profit sharing were \$722,000 and \$0 for the year ended December 31, 2003 and 2002. We earned total management fees and other related income of \$10,826,000 and \$9,455,000, including expense reimbursements, principally for our independent agents' commissions, of \$3,373,000 and \$3,368,000 for the years ended December 31, 2003 and 2002, respectively, related to these agreements.

The summarized financial information for APIE as of and for the year ended December 31, 2003 and 2002 is as follows:

	2003 (unaudited)	2002
	-----	-----
Invested assets	\$86,547,000	\$67,293,000
Other assets	16,181,000	13,428,000
	-----	-----
Total Assets	\$102,728,000	\$80,721,000
	=====	=====
Current liabilities	\$86,945,000	\$67,736,000
Surplus	15,783,000	12,985,000
	-----	-----
Total liabilities and surplus	\$102,728,000	\$80,721,000
	=====	=====
Total revenue	\$56,006,000	\$41,078,000
Net income	\$ 1,299,000	\$ 1,503,000

A-14

(2) MANAGEMENT FEES AND OTHER RECEIVABLES, continued

Other receivables in 2003 are primarily from our brokerage and investment advisory services and are principally comprised of commissions earned by our brokers for trades in the last week of December 2003 and 2002.

(3) NOTES RECEIVABLE

Notes receivable consist of the following:

FemPartners, Inc. (Formerly due from Syntera HealthCare Corporation) Promissory note, bears interest at 8%. Payments were interest only, paid quarterly through November 30, 2001. Quarterly combined principal and interest payments began December 1, 2001 and were to continue through September 1, 2004, at which time the total outstanding balance was due. In December 2003 we agreed to extend the maturity one year interest only at 8%. The remaining principal and interest payments are due March 1, June 1, and September 1, 2005. The maturity date of this note can be accelerated if FemPartners conducts an initial public offering or other public sale of its common stock. If such occurs, the note shall mature and become due and payable on the 5th business day after the date of such initial public offering or other public sale.

Unsecured term note, principal and interest, at 8%, payable monthly until maturity on March 31, 2004. Paid in full during 2003.

#### EMPLOYEES

Loans are periodically made to non-officer employees, primarily as employment retention inducements. Employee notes receivable at December 31, 2003 consisted of a note totaling \$6,000, which is being amortized through December 15, 2005, provided the employee remains with us, and two loans totaling \$26,000 to a key employee for advanced education fees. The latter two notes are forgivable in the amount of approximately \$13,000 on each January 1st that the employee is employed by the Company beginning in 2001 and continuing through 2005. They are due within 90 days should the employee terminate employment.

Employee notes receivable at December 31, 2002 consisted of a note totaling \$4,000 which is being amortized through 2004, provided the employee remains with us and two loans totaling \$40,000 to a key employee for advanced education fees. The same terms apply as described above.

Less current portion and allowance for doubtful accounts of \$64,000 in 2002

Long term portion

A-15

#### (4) FAIR VALUE OF FINANCIAL INSTRUMENTS

For financial instruments the estimated fair value equals the carrying value as presented in the consolidated balance sheets. Fair value estimates, methods, and assumptions are set forth below for our financial instruments.

#### CASH AND CASH EQUIVALENTS

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

The carrying amounts for cash and cash equivalents approximate fair value because they mature in less than 90 days and do not present unanticipated credit concerns.

### TRADING ACCOUNT SECURITIES

The trading account securities owned are reported at fair value. In the absence of any available market quotation, securities held by us are valued at estimated fair value as determined by management.

### AVAILABLE-FOR-SALE SECURITIES

Available-for-sale securities owned are reported at fair value, based upon quoted market prices.

### ACCOUNTS RECEIVABLE

The fair value of these receivables approximates the carrying value due to their short-term nature and historical collectibility

### MANAGEMENT FEES AND OTHER RECEIVABLES

The fair value of these receivables approximates the carrying value due to their short-term nature and historical collectibility.

### NOTES RECEIVABLE

The fair value of notes has been determined using discounted cash flows based on our management's estimate of current interest rates for notes of similar credit quality. The carrying value of notes receivable approximates their fair value.

### DEPOSIT WITH CLEARING ORGANIZATION

The carrying amounts approximate fair value because the funds can be withdrawn on demand and there is no unanticipated credit concern.

### ACCOUNTS PAYABLE

The fair value of the payable approximates carrying value due to the short-term nature of the obligation.

### LIMITATIONS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. Fair value estimates are based on existing financial instruments

A-16

#### (4) FAIR VALUE OF FINANCIAL INSTRUMENTS, continued

without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the aforementioned estimates.

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

(5) MARKETABLE SECURITIES

The following table summarizes by major security type the cost, fair market value, and unrealized gains and losses of the investments that we have classified as available-for-sale:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair
December 31, 2003				
Corporate obligations	\$ 884,000	\$ 13,000	\$ --	\$ 897,000
Equity securities	9,306,000	--	(577,000)	8,729,000
Total	\$10,190,000	\$ 13,000	\$ (577,000)	\$9,626,000
December 31, 2002				
U.S. government agencies	\$ 2,846,000	\$ 60,000	\$ --	\$2,906,000
Corporate obligations	1,379,000	19,000	(16,000)	1,382,000
Equity securities	4,287,000	2,762,000	(53,000)	6,996,000
Total	\$8,512,000	\$2,841,000	\$ (69,000)	\$11,284,000

Maturities of fixed income securities were as follows at December 31, 2003:

	Cost	Fair Value
Due within one year	--	--
Due after one year	884,000	897,000
Total	\$ 884,000	\$ 897,000

Amounts reflected in the tables above include equity securities of Prime Medical Services, Inc. ("Prime Medical") with a fair value of \$3,416,000 and \$6,525,000 and corporate obligations of Prime Medical with a fair value of \$897,000 and \$860,000 at December 31, 2003 and 2002, respectively. At December 31,

A-17

(5) MARKETABLE SECURITIES, continued

2003, amounts also include equity securities of Financial Industries Corporation ("FIC") with a fair value of \$5,313,000. As of December 31, 2003, management believes the gross unrealized loss to represent temporary declines in the investments' fair values and, accordingly, no

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

impairment charges have been recognized.

Prime Medical is the largest provider of lithotripsy (a non-invasive method of treating kidney stones) services in the United States and is an international supplier of specialty vehicles for the transport of high technology medical, broadcast/communications and homeland security equipment. Through selling of shares since our initial investment of 3,540,000 shares in 1989, our holdings of common stock at December 31, 2003 stood at 728,400, or approximately 4% of the common stock outstanding. We account for FIC as an available-for-sale equity security and record changes in their value, net of tax, in our balance sheet as part of "accumulated other comprehensive income".

In June 2003 we purchased 385,000 shares of FIC for approximately \$5,000,000, which was sourced from our cash reserves. These shares represent approximately 4% of the outstanding shares of FIC. We account for FIC as an available-for-sale equity security and record changes in their value, net of tax, in our balance sheet as part of "accumulated other comprehensive income".

The following table summarizes our recognized gains and losses on investments. Costs on assets sold were determined on the basis of specific identification.

	Year ended December 31,	
	2003	2002
Proceeds from sales	\$ 4,080,000	\$ 10,731,000
Gains	197,000	2,855,000
Losses	(70,000)	--
	-----	-----
Net gains	\$ 127,000	\$ 2,855,000
	=====	=====

### (6) PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31,	
	2003	2002
Equipment	\$1,059,000	\$1,022,000
Furniture	624,000	578,000
Software	323,000	319,000
Leasehold improvements	332,000	240,000
	-----	-----
	\$2,338,000	\$2,159,000
Accumulated depreciation and amortization	\$ (1,960,000)	\$ (1,830,000)
	-----	-----
	\$ 378,000	\$ 329,000
	=====	=====

A-18

### (7) ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consists of the following as of

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

December 31:

	2003	2002
	-----	-----
Commissions payable	\$ 964,000	\$ 798,000
Taxes payable	116,000	93,000
401(k) plan matching	121,000	--
Vacation payable	158,000	144,000
Other	126,000	127,000
	-----	-----
	\$1,485,000	\$1,162,000
	=====	=====

(8) DEFERRED GAIN

In November 2001 we sold all of the remaining 46,000 square feet of condominium space we owned in an office project located in Austin, Texas to our former affiliate, Prime Medical. In conjunction with the sale we leased back approximately 23,000 square feet that housed our operations prior to the sale. Gain on the sale amounted to approximately \$5.1 million, of which \$1.9 million was recognized in 2001 and the balance of gain was deferred. Deferred income of approximately \$2.4 million related to our continuing involvement in 50% of the useable space was recorded and is being recognized monthly over the five-year lease term through November 2006. Income recognition related to this deferral was \$488,000 in 2003 and 2002. In addition, 15% of the gain (\$0.76 million) related to our then 15% ownership in the purchaser was deferred as we accounted for Prime Medical using the equity method of accounting through the year ended December 31, 2001. During 2003 and 2002 we reduced our investment in Prime Medical and subsequently recognized a proportionate percentage of the deferred gain, amounting to \$8,000 in 2003 and \$515,000 in 2002. Recognition of the deferred gain is recorded as a reduction of rent expense in operating expenses in the accompanying financial statements.

(9) COMMITMENTS AND CONTINGENCIES

Expenses under all operating leases for the years ended December 31, 2003 and 2002 were \$997,000 and \$1,077,000, respectively. Future minimum payments for leases that extend for more than one year through 2008 were \$964,000; \$810,000; \$510,000; \$8,000 and \$0 for 2004, 2005, 2006, 2007 and 2008, respectively.

We are involved in various claims and legal actions that have arisen in the ordinary course of business. Management believes that any liabilities arising from these actions will not have a significant adverse effect on our consolidated financial condition or results of operations.

A-19

(10) INCOME TAXES

Income tax expense consists of the following:

	Year Ended December 31,
	-----
	2003
	2002

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Continuing Operations	-----	-----
Federal		
Current	\$ (978,000)	\$2,339,000
Deferred	2,511,000	(151,000)
State-Current	107,000	95,000
	-----	-----
Total from Continuing Operations	1,640,000	2,283,000
Discontinued Operations	14,000	--
	-----	-----
	\$1,654,000	\$2,283,000
	=====	=====

A reconciliation of expected income tax expense computed by applying the United States federal statutory income tax rate of 34% to earnings from continuing operations before income taxes to tax expense from continuing operations in the accompanying consolidated statements of operations follows:

	Year Ended December 31,	
	-----	-----
	2003	2002
	-----	-----
Expected federal income tax expense from		
continuing operations	\$1,500,000	\$1,849,000
State taxes	72,000	63,000
Goodwill adjustment	--	214,000
Minority interest	67,000	89,000
Other, net	1,000	68,000
	-----	-----
	\$1,640,000	\$2,283,000
	=====	=====

A-20

(10) INCOME TAXES, CONTINUED

The tax effect of temporary differences that gives rise to significant portions of deferred tax assets and deferred tax liabilities at December 31, 2003 and 2002 are presented below:

	-----	Ye
	2003	
	-----	
Deferred tax assets:		
Market value allowance on investments		\$ 191,000
Accrued expenses		357,000
Allowance for doubtful accounts		6,000
Investment in available-for-sale securities and equity investees		--
Other investments		126,000
Sales/Leaseback deferred income		564,000
Other		54,000

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Total gross deferred tax assets	\$1,298,00
Deferred tax liabilities:	
Investment in available-for-sale securities	(889,00
Market value allowance on investments	-
Capitalized expenses, principally due to deductibility for tax purposes	(23,00
Total gross deferred tax liabilities	(912,00
Net deferred tax asset	\$ 386,00

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods that the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2003.

(11) EMPLOYEE BENEFIT PLANS

We have an employee benefit plan qualifying under Section 401(k) of the Internal Revenue Code for all eligible employees. Employees become eligible upon meeting certain service and age requirements. Employee deferrals may not exceed \$12,000 in 2003 unless participant is over age 50, in which case the maximum deferral is \$14,000. We may, at our discretion, contribute up to 200% of the employees' deferred amount. For the years ended December 31, 2003 and 2002 our contributions aggregated \$176,000 and \$135,000 respectively.

A-21

(12) STOCK OPTIONS

We have adopted, with shareholder approval, the "1995 Non-Employee Directors Stock Option Plan" ("Directors Plan") and the "1995 Incentive and Non-Qualified Stock Option Plan" ("Incentive Plan"). The Directors Plan provides for the issuance of up to 200,000 shares of common stock to non-employee directors who serve on the Compensation Committee. The Directors Plan is inactive and it is assumed the remaining 170,000 shares will not be granted. The Incentive Plan, as amended with shareholder approval in 1998, 2001, and 2002 provides for the issuance of up to 1,600,000 shares of common stock to our directors and key employees. A total of 1,305,000 of these options have been granted as of December 31, 2003.

The exercise price for each non-qualified option share is determined by the Compensation Committee of the Board of Directors ("the Committee"). The exercise price of a qualified incentive stock option has to be at least 100% of the fair market value of such shares on the date of grant



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

of the option. Under the Plans, option grants are limited to a maximum of ten-year terms; however, the Committee has issued all currently outstanding grants with five-year terms. The Committee also determines vesting for each option grant and substantially all outstanding options vest in two or three approximately equal annual installments beginning one year from the date of grant.

The fair value of the options is estimated under Statement 123 using the Black Scholes option-pricing model with the following assumptions:

	2003 -----	2002 -----
Risk-free interest rate	2.44%	3.40%
Expected holding period	3.8 years	3.7 years
Expected volatility	.407	.477
Expected dividend yield	-0-	-0-

Presented below is a summary of the stock options held by our employees and our directors and the related transactions for the years ended December 31, 2003 and 2002.

	Year Ended December 31,			
	2003 -----		2002 -----	
	Shares -----	Weighted Average Exercise Price -----	Shares -----	Weighted Average Exercise Price -----
Balance at January 1	939,000	\$3.51	788,000	\$3.45
Options granted	330,000	6.46	305,000	3.72
Options exercised	(378,000)	3.57	(13,000)	1.69
Options repurchased	(15,000)	4.29	(89,000)	2.38
Options forfeited/expired	(61,000)	5.73	(52,000)	6.26
Balance at December 31	815,000	4.49	939,000	3.51
Options exercisable	289,000	\$3.01	500,000	\$3.78
	=====	=====	=====	=====

A-22

### (12) STOCK OPTIONS, continued

The weighted average fair value (the theoretical option value calculated using the Black Scholes option pricing model) of Company stock options granted during the years ended December 31, 2003 and 2002 is \$2.20 and \$1.46 per option, respectively. In this case, as of December 31, 2003, the weighted average theoretical option value per

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

share of Company stock options (\$8.66) less the weighted average exercise price of options granted (\$6.46) equals the weighted average fair value of options granted (\$2.20).

The following table summarizes the Company's options outstanding and exercisable options at December 31, 2003:

Stock Options Outstanding				Stock Options
Range of Exercise Prices	Shares	Average Remaining Contractual Life	Weighted Average Exercise Price	Shares
\$1.50 to 4.50	665,000	2.8 years	\$3.45	289,000
\$4.51 to \$9.10	150,000	4.9 years	\$9.10	--
Total	815,000			289,000

### (13) DISCONTINUED OPERATIONS

Effective November 1, 2002, we completed the sale of APS Consulting to its management as we determined the division's operations were not consistent with our long-term strategic plan. We sold all of our APS Consulting shares for a de minimus amount of cash plus a \$250,000 seven-year term note at the prime rate plus 3%. Our existing contract, which was entered into October 1, 2002, provides administrative support services to APS Consulting for a period of approximately seven years, and remained in effect. Fees under this contract are dependent on APS Consulting's pre-tax earnings but may not be less than \$200,000 or more than \$518,000 over the life of the agreement. Because we were dependent upon the future successful operation of the division to collect our proceeds from the disposal and because we had a security interest in the assets of the division, we had retained a sufficient risk of loss to preclude us from recognizing the divestiture of APS Consulting under the guidance of FASB Interpretation No 46. Accordingly, we did not recognize the divestiture of APS Consulting and continued to consolidate the division as an entity in which we have a variable interest that will absorb the majority of the entity's operating losses if they occurred.

Effective November 1, 2003, APS Consulting was able to obtain third party financing and repay their note payable to us in exchange for our agreeing to discount the note by \$35,000. We provided no guarantees or credit enhancements in connection with APS Consulting securing this financing. Accordingly, we no longer have a risk of loss related to these operations and have recognized the transaction as a divestiture. As a result, we ceased consolidation of APS Consulting financial statements effective November 1, 2003. In addition, we were able to recognize a gain of \$27,000, net of tax, and administrative support fees totaling \$84,000 for the period from November 1, 2002 through October 31, 2003 that had previously been eliminated as intercompany revenues.

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

The accompanying financial statements reflect the financial position, results of operations and cash flows of APS Consulting as discontinued operations.

A-23

### (13) DISCONTINUED OPERATIONS, continued

A summary of assets and liabilities related to discontinued operations as of December 31, 2002 is as follows:

	2002
ASSETS	-----
Cash	\$ 347,000
Accounts Receivable, net	409,000
Prepaid Expenses	22,000
	-----
Total Current Assets	778,000
Property and Equipment	45,000
	-----
Total Assets	\$ 823,000
	=====
LIABILITIES	
Accounts Payable	\$ 445,000
Accrued Expenses	74,000
	-----
Total Current Liabilities	519,000
Notes Payable	248,000
Deferred Income	74,000
	-----
Total Liabilities	\$ 841,000
	=====
Total Liabilities in excess of Assets	\$ 18,000
	=====

A summary of results of operations related to discontinued operations for the years ended December 31, 2003 and 2002 is as follows:

	2003	2002
	-----	-----
Consulting Revenue	--	\$ 3,296,000
Consulting Expenses	--	2,909,000
	-----	-----
Net Income	--	\$ 387,000
	=====	=====

### (14) REPURCHASE OF MINORITY INTEREST

On October 1, 2003 we purchased for \$2,050,000 the 20% interest in APS

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Insurances Services, Inc., which was owned by FPIC Insurance Group, Inc. ("FPIC"). We believe the acquisition will provide us more control over operating decisions and will improve our earnings and return on capital with minimal risk. As a result of this transaction, we now own a 100% interest in APS Insurance Services. Prior to our repurchase of the minority interest, we consolidated the assets, liabilities and operations of APS Insurance Services and recorded 20% of its after tax net income as minority interest. As a part of the purchase agreement we maintained an agreement with FPIC that limits them from competing with us in Texas through February

A-24

### (14) REPURCHASE OF MINORITY INTEREST, continued

2007. The Company has assigned a value of \$400,000 to this non-compete agreement, which is being amortized on the straight-line method through its expiration in 2007.

The total cost of the acquisition was \$2,050,000 and was allocated to the 20% interest acquired in APS Insurance Services based on the fair values of its net assets on the date of acquisition, in accordance with the purchase method of accounting for business combinations. The balances included in the Consolidated Balance Sheets related to the acquisition are based upon preliminary information and are subject to change when final asset and liability valuations are determined. Final valuations of assets and liabilities are determined and recorded within one year from the date of the acquisition. Material changes in the preliminary allocations are not anticipated by management. A summary of the purchase price allocation for this transaction is as follows:

Purchase price of 20% interest	\$2,050,000
Basis of recorded minority interest	(393,000)
Allocated to non-competition agreement	(400,000)
	-----
Excess of purchase price over assets acquired (goodwill)	\$1,257,000
	=====

The unaudited pro forma income statements below show the impact of the repurchase as if it had happened prior to the reporting periods:

	Year Ended December 31,	
	2003	2002
	-----	-----
Revenue:		
As reported	\$30,449,000	\$23,077,000
Pro forma	\$30,449,000	\$23,077,000
Net earnings as reported	\$2,799,000	\$ 3,411,000
Add: Minority Interest attributable to APS Insurance Services, net of income taxes	\$ 197,000	\$ 268,000
	-----	-----
Pro forma net earnings	\$ 2,996,000	\$ 3,679,000
	=====	=====

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Earnings per share:		
Basic - as reported	\$1.27	\$1.53
	=====	=====
Basic - pro forma	\$1.36	\$1.65
	=====	=====
Diluted - as reported	\$1.14	\$1.45
	=====	=====
Diluted - pro forma	\$1.22	\$1.57
	=====	=====

As of December 31, 2003, the net carrying value of the non-compete agreement was \$371,000, net of \$29,000 accumulated amortization recognized during 2003.

A-25

(14) REPURCHASE OF MINORITY INTEREST, continued

We assume no residual value and estimate annual amortization expense over the remaining life of the agreement to be as follows:

Year	Amount
-----	-----
2004	\$117,000
2005	117,000
2006	117,000
2007	20,000

(15) INVESTMENT IN UNCONSOLIDATED AFFILIATES

For the year ended December 31, 2003 and 2002, respectively, our equity in the gain (loss) of unconsolidated affiliates consisted of the following:

	December 31,	
	-----	-----
	2003	2002
Prime Medical Services, Inc.	--	\$ 186,000
Uncommon Care	\$ 260,000	(230,000)
	-----	-----
Gain (loss)	\$ 260,000	\$ (44,000)
	=====	=====

On October 12, 1989, we purchased 3,540,000 shares (42%) of the common stock of Prime Medical. In the ensuing years, the sale of stock, stock exchanges and stock issuances reduced our ownership and at December 31,

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

2003 our holdings stood at 728,400 or approximately 4% of the common stock outstanding.

In the first quarter of 2002, with the sale of Prime Medical shares reducing our ownership to less than 5%, and our chairman and CEO reducing his responsibilities on Prime's Board, we discontinued the use of the equity method and began to account for our Prime Medical investment as an available-for-sale equity security. Prior to discontinuing equity method accounting on March 1, 2002 we recorded equity in Prime Medical's earnings of \$186,000. In connection with the sales of Prime Medical shares during the year, we recognized a gain of \$64,000 in 2003 and \$2,855,000 in 2002. The gains are classified as "Gain on Sale of Investments" in the accompanying consolidated financial statements. Changes in market value of our Prime Medical shares are included in shareholders equity as "accumulated other comprehensive income".

Prime is an SEC registrant and additional information on the company can be found on the SEC's web site at [www.sec.gov](http://www.sec.gov).

On January 1, 1998 we invested approximately \$2,078,000 in the convertible preferred stock of Uncommon Care, Inc. and extended notes totaling \$4,430,000. Uncommon Care is a developer and operator of Alzheimer's care facilities. We accounted for Uncommon Care using the equity method.

A-26

### (15) INVESTMENT IN UNCONSOLIDATED AFFILIATES, continued

Recording our share of Uncommon Care's accumulated losses had reduced the carrying value of our investment and our notes to zero by December 31, 2002. Following Uncommon Care's payment default to its senior lender in 2003 we sold our interest for a de minimus amount and wrote off the notes.

Some of our officers and directors participated in the \$2,400,000 line of credit to Uncommon Care. For financial purposes this participation has been treated as a secured borrowing. In the aggregate, these officers and directors contributed approximately \$259,000 to fund a 10.8% interest in the loan. They participate in the loan under the same terms as the Company.

During 2002 we expensed the \$230,000 that we advanced under the lines of credit. As this advance represented a funding of Uncommon Care's prior losses, the amount was expensed when advanced and is included in the equity in loss related to this affiliate. Repayments on the line of credit during 2002 were \$85,000 and were recorded as deferred income to offset possible future advances.

During 2003 we decided not to extend any future cash advances to Uncommon Care. Consequently, we took into income cash payments previously received from Uncommon Care. Total cash receipts recorded as equity in earnings of unconsolidated affiliates was \$260,000 in 2003.

### (16) SEGMENT INFORMATION

Our segments are distinct by type of service provided. Each segment has

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

its own management team and separate financial reporting. Our Chief Executive Officer allocates resources and provides overall management based on the segments' financial results.

Our financial services segment includes brokerage and asset management services to individuals and institutions.

Our insurance services segment includes financial management for an insurance company that provides professional liability insurance to doctors.

Corporate is the parent company and derives its income from interest, investments and dividends paid by the other segments.

Income from the discontinued consulting segment was derived from operations in 2002 and from gains on disposal in 2003.

A-27

	2003
	-----
OPERATING REVUENUES	
Financial services	\$ 19,623
Insurance services	10,826
Other	2,567
	-----
	\$ 33,016
	=====
RECONCILIATION TO CONSOLIDATED STATEMENTS OF OPERATIONS:	
Total segment revenues	33,016
Less: intercompany dividends	(2,567)
	-----
Total Revenues	\$ 30,449
	=====
OPERATING INCOME (LOSS):	
Financial services	3,039
Insurance services	2,985
Other	506
	-----
	\$ 6,530
	=====
RECONCILIATION TO CONSOLIDATED STATEMENTS OF OPERATIONS:	
Total segment operating profit	\$ 6,530
Less: intercompany dividends	(2,567)
	-----
Operating income	3,963
Gain on sale of investments	127
	-----
Income from continuing operations before interest, income taxes, minority interests and equity in gain and loss of unconsolidated affiliates	4,090
Interest income	304
Other loss	(38)
Interest expense	7
Income tax expense	1,640
Minority interests	197

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Equity in profit (loss) of affiliates	260
	-----
Income from continuing operations	2,772
Net income from discontinued operations, net of income tax	
Gain on disposal of discontinued operations, net of income tax	27
	-----
Net income	\$ 2,799
	=====

A-28

(16) SEGMENT INFORMATION, continued

	2003	
	-----	-----
Identifiable assets:		
Financial services	\$ 4,970,000	\$ 3,
Insurance services	3,965,000	2,
Corporate:		
Intangible assets	1,627,000	
Investment in available for sale securities	9,626,000	11,
Other	5,450,000	6,
	-----	-----
	\$25,638,000	\$24,
	=====	=====
Capital expenditures:		
Financial services	\$ 32,000	\$
Insurance Services	160,000	
Corporate	31,000	
	-----	
	\$ 223,000	\$
	=====	
Depreciation/amortization expenses:		
Financial services	\$ 31,000	\$
Insurance Services	77,000	
Corporate	65,000	
	-----	
	\$ 173,000	\$
	=====	

Capital expenditures at our discontinued segment were \$96,000 and \$15,000 in 2003 and 2002, respectively.

During the years ended December 31, 2003 and 2002, a single customer represented 36% (\$10,826,000) and 41% (\$9,454,000) of our consolidated revenues.

At December 31, 2003 and 2002 we had long-term contracts with that customer and were therefore not vulnerable to the risk of a near-term severe impact from a reasonably possible loss of the revenue. However,



## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

should that customer default or be unable to satisfy its contractual obligations, there would be a material adverse effect on our financial condition and results of operations.

Operating income (loss) is operating revenues less related expenses and is all derived from domestic operations. Identifiable assets are those assets that are used in the operations of each business segment (after elimination of investments in other segments). Corporate assets consist primarily of cash and cash equivalents, notes receivable, investments in available-for-sale securities, investments in affiliates and intangible assets.

A-29

### (17) NET INCOME PER SHARE

Basic income per share are based on the weighted average shares outstanding without any dilutive effects considered. Diluted earnings per share reflects dilution from all contingently issuable shares, including options. A reconciliation of income and average shares outstanding used in the calculation of basic and diluted earnings per share from continuing and discontinued operations follows:

	For the Year Ended December 31, 2003		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Income from continuing operations	\$2,772,000		
Discontinued operations, net of tax	27,000		
Basic EPS:			
Income available to common stockholders	2,799,000	2,207,000	\$1.27
Effect of dilutive securities	--	242,000	=====
	-----	-----	
Diluted EPS:			
Income available to common stockholders	\$2,799,000	2,449,000	\$1.14
	=====	=====	=====
	For the Year Ended December 31, 2002		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Income from continuing operations	\$3,156,000		
Discontinued operations, net of tax	255,000		
Basic EPS:			
Income available to common stockholders	3,411,000	2,227,000	\$1.53
Effect of dilutive securities	--	118,000	=====
	-----	-----	
Diluted EPS:			
Income available to common stockholders	\$3,411,000	2,345,000	\$1.45
	=====	=====	=====

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Unexercised employee stock options to purchase 191,250 and 432,000 shares of our common stock for the years ended December 31, 2003 and 2002, respectively, were not included in the computations of diluted EPS because their effect would be antidilutive.

A-30

(18) SHAREHOLDERS' EQUITY

The following table presents changes in shares outstanding for the period from December 31, 2001 to December 31, 2003:

	Common Shares Outstanding	Treasury Stock
-----		
Balance December 31, 2001	2,745,231	386,000
Options excercised	13,000	--
Treasury stock purchases	--	238,388
Treasury stock retirements	(624,388)	(624,388)
	-----	-----
Balance December 31, 2002	2,133,843	--
	=====	=====
Options excercised	377,800	--
Treasury stock purchases	--	56,976
Treasury stock retirements	(56,976)	(56,976)
	-----	-----
Balance December 31, 2003	2,454,667	--
	=====	=====

(19) QUARTERLY RESULTS (UNAUDITED)

Quarter to quarter comparisons of results of operations have been and may be materially impacted by bond market conditions and whether or not there are profits at the medical malpractice insurance company which we manage and whose profits we share. We believe that the historical pattern of quarterly sales and income as a percentage of the annual total may not be indicative of the pattern in future years. The following tables set forth selected quarterly consolidated statements of operations information for the years ended December 31, 2003 and 2002:

A-31

2003	First Quarter	Second Quarter	Third Quarter
	-----	-----	-----

(In thousands, except per sha

Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

Revenues	\$ 6,616	\$ 6,946	\$ 9,047
Income from continuing operations	551	683	731
Discontinued operations, net of taxes	--	--	--
Net income	551	683	731
Basic net income per share:			
From continuing operations	\$ 0.26	\$ 0.32	\$ 0.34
Discontinued operations, net of taxes	--	--	--
Net income	\$ 0.26	\$ 0.32	\$ 0.34
Diluted income per share:			
From continuing operations	\$ 0.25	\$ 0.30	\$ 0.31
Discontinued operations, net of taxes	--	--	--
Net income	\$ 0.25	\$ 0.30	\$ 0.31
2002			
Revenues	\$ 5,206	\$ 5,442	\$ 6,254
Income from continuing operations	2,558	335	204
Discontinued operations, net of taxes	44	114	92
Net income	2,602	449	296
Basic net income per share:			
From continuing operations	\$ 1.10	\$ 0.15	\$ 0.09
Discontinued operations, net of taxes	\$ 0.02	\$ 0.05	\$ 0.04
Net income	\$ 1.12	\$ 0.20	\$ 0.13
Diluted income per share:			
From continuing operations	\$ 1.06	\$ 0.14	\$ 0.09
Discontinued operations, net of taxes	\$ 0.02	\$ 0.05	\$ 0.04
Net income	\$ 1.07	\$ 0.19	\$ 0.13

A-32

(19) QUARTERLY RESULTS (UNAUDITED), continued

Results for the first quarter of 2002 include gains on the sale of 1,570,000 shares of Prime Medical common stock totaling \$2,802,000 pre-tax. In connection with these sales, we also recognized a portion

## Edgar Filing: AMERICAN PHYSICIANS SERVICE GROUP INC - Form 10KSB

of the \$760,000 gain on sale of real estate related to our 15% interest in Prime. Such gains recognized in the first quarter were approximately \$500,000. Results for the fourth quarter of 2002 include an adjustment increasing federal income tax expense by \$214,000. This adjustment represents a one-time tax adjustment relating to APS Consulting. Results for the fourth quarter of 2003 include profit sharing with APIE totaling \$722,000.

### (20) CONCENTRATION OF CREDIT RISK

#### MARKETABLE SECURITIES

As of December 31, 2003 we owned marketable securities of Prime Medical and Financial Industries Corporation with a combined fair market value of \$9,627,000, or approximately 37% of our total assets. An event having a material adverse effect on Prime Medical and/or Financial Industries, and resulting in a devaluation of their securities would also have a material adverse effect on our financial condition and results of operations.

#### GEOGRAPHIC CONCENTRATION OF INSURANCE SERVICES

Most of the managed insurance company's business is concentrated in Texas. Regulatory or judicial actions in that state that affected rates, competition, or tort law could have a significant impact on the insurance company's business. Consequently, our insurance management business, which is based on the premiums and profitability of the managed company, could be adversely affected.

#### FINANCIAL MARKET CONCENTRATION OF INVESTMENT SERVICES

Investment Services derives most of its revenue through commissions earned on the trading of fixed-income securities. Should conditions reduce the market's demand for fixed-income products, and should Investment Services be unable to shift its emphasis to other financial products, it could have a material adverse impact on our financial condition and results of operations.