

AMERICAN PHYSICIANS SERVICE GROUP INC  
Form 10QSB  
May 15, 2003

=====

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE PERIOD ENDED MARCH 31, 2003

or

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

to

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COMMISSION FILE NUMBER 0-11453

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

TEXAS  
(State or other jurisdiction of  
incorporation or organization)

75-1458323  
(I.R.S. Employer  
identification No.)

1301 CAPITAL OF TEXAS HIGHWAY AUSTIN, TEXAS  
(Address of principal executive offices)

78746  
(Zip Code)

(512) 328-0888  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES      X              NO  
-----              -----

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

TITLE OF EACH CLASS	NUMBER OF SHARES OUTSTANDING AT	May 5, 2003
-----		-----
Common Stock, \$.10 par value		2,127,130

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PART I

FINANCIAL INFORMATION

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

Item 1 - Financial Statements

(In thousands)

	Three Months Ended March 31,	
	2003	2002
	-----	-----
Revenues:		
Financial services	\$4,057	\$3,097
Insurance services	2,557	2,109
Consulting	899	697
Other	2	--
	-----	-----
Total revenue	7,515	5,903
Expenses:		
Financial services	3,340	2,612
Insurance services	1,972	1,595
Consulting	626	630
General and administrative	426	361
Gain on sale of assets (Note 4)	(2)	(572)
	-----	-----
Total expenses	6,362	4,626
	-----	-----
Operating income	1,153	1,277
Gain on sale of investments (Note 4)	15	2,801
Earnings from operations before interest, income taxes, minority interests and equity in loss of unconsolidated affiliates	1,168	4,078
Interest income	71	38
Interest expense	1	18
Income tax expense	437	1,395
Minority interests (Note 9)	249	57
Equity in loss of unconsolidated affiliates (Note 5)	--	(44)
	-----	-----

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Net earnings	\$552 =====	\$2,602 =====
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See accompanying notes to consolidated financial statements.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENT OF EARNINGS PER SHARE (UNAUDITED)

(In thousands, except per share amounts)

	Three Months Ended March 31,	
	2003	2002
	-----	-----
Earnings (loss) per common share		
Basic:		
Earnings from operations	\$0.26	\$1.12
	-----	-----
Net earnings	\$0.26	\$1.12
	=====	=====
Diluted:		
Earnings from operations	\$0.25	\$1.07
	-----	-----
Net earnings	\$0.25	\$1.07
	=====	=====
Basic weighted average shares outstanding	2,132	2,323
	=====	=====
Diluted weighted average shares outstanding	2,228	2,422
	=====	=====

See accompanying notes to consolidated financial statements.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

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(In thousands)

	March 31, 2003 ----- (Unaudited)	December 31, 2002 -----
ASSETS		
Current Assets:		
Cash and cash equivalents	\$6,331	\$6,691
Trading account securities	133	133
Trade receivables, net	653	460
Notes receivable - current	688	571
Management fees and other receivables	743	763
Deposit with clearing organization	500	500
Receivable from clearing organization	70	70
Investment in available-for-sale fixed income securities - current	1,010	1,015
Income tax receivable	98	491
Prepaid expenses and other	644	673
	-----	-----
Total current assets	10,870	11,367
Notes receivable, less current portion	221	374
Property and equipment, net	388	374
Investment in available-for-sale equity securities (Note 5)	6,565	6,996
Investment in available-for-sale fixed income securities - non-current	2,793	3,273
Net deferred income tax asset - non-current	2,357	2,399
Other assets	197	198
	-----	-----
Total Assets	\$23,391 =====	\$24,981 =====

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

	March 31, 2003 -----
LIABILITIES AND SHAREHOLDERS' EQUITY	(Unaudited)

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Current liabilities:

Accounts payable - trade	\$724
Payable to clearing broker	80
Accrued incentive compensation	566
Accrued expenses and other liabilities (Note 6)	1,264
Deferred gain - current	488
Deferred tax liability - current	614
	-----
Total current liabilities	3,736
Payable under loan participation agreements	259
Deferred gain - non-current	1,762
	-----
Total liabilities	5,757
Minority interests (Note 9)	632
Shareholders' Equity:	
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, none issued or outstanding	--
Common stock, \$0.10 par value, shares authorized 20,000,000; 2,130,043 issued and outstanding at 03/31/03 and 2,133,843 at 12/31/02	213
Additional paid-in capital	5,584
Retained earnings	10,053
Accumulated other comprehensive income (loss), net of taxes	1,152
	-----
Total shareholders' equity	17,002
	-----
Total Liabilities and Shareholders' Equity	\$23,391
	=====

See accompanying notes to consolidated financial statements.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

Three Months  
2003

Cash flows from operating activities:

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Net income	\$552
Adjustments to reconcile net income to cash used in operating activities:	
Depreciation and amortization	50
Forgiveness of debt and other	41
Minority interest in consolidated earnings	239
Undistributed loss of affiliates	--
Gain on sale of assets	(124)
Loss (gain) on sale of investment	19
Provision for bad debt	21
Changes in operating assets and liabilities:	
Trade receivables	(198)
Trading account securities	0
Income tax receivable	393
Deferred income taxes	53
Receivable from clearing organization	10
Management fees & other receivables	20
Prepaid expenses & other assets	29
Trade accounts payable	(15)
Deferred income	--
Accrued expenses & other liabilities	(1,201)
Net cash used in operating activities	----- (111)
Cash flows from investing activities:	
Capital expenditures	(58)
Proceeds from the sale of an investment	612
Purchase of available-for-sale securities	(812)
Investments in and advances to affiliate	--
Funds loaned to others	(150)
Collection of notes receivable	129
Other	44
Net cash (used in) provided by investing activities	----- (235)
Cash flows from financing activities:	
Payment of long term debt	--
Purchase and cancellation of treasury stock	(14)
Net cash used in financing activities	----- (14)
Net change in cash and cash equivalents	(\$360)
Cash and cash equivalents at beginning of period	6,691
Cash and cash equivalents at end of period	----- \$6,331 =====

See accompanying notes to consolidated financial statements.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)  
For the three months ended March 31, 2002 and 2003

(In thousands)

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	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income (loss)	Accum Ot Compre Income
Balance December 31, 2001 (audited)	\$ 275	\$ 5,539	\$ 8,310		\$ (
Comprehensive income:					
Net income	--	--	2,602	\$ 2,602	
Other comprehensive income:					
Unrealized gain on securities, net of taxes of \$710	--	--	--	1,380	1,
Comprehensive income	--	--	--	\$ 3,982	
Treasury stock purchase	--	--	--	--	
Balance March 31, 2002 (unaudited)	\$ 275	\$ 5,539	\$ 10,912	\$ --	\$ 1,
Balance December 31, 2002 (audited)	\$ 213	\$ 5,584	\$ 9,515		\$ 1,
Comprehensive income:					
Net income	--	--	552	\$ 552	
Other comprehensive income:					
Unrealized loss on securities, net of taxes of \$349	--	--	--	(678)	(
Comprehensive loss	--	--	--	\$ (126)	
Treasury stock purchases	--	--	--		
Cancelled treasury stock	--	--	(14)		
Balance March 31, 2003 (unaudited)	\$ 213	\$ 5,584	\$10,053	\$ --	\$ 1

See accompanying notes to consolidated financial statements

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AMERICAN PHYSICIANS SERVICE GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
March 31, 2003  
(Unaudited)

1. GENERAL

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the

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Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The consolidated financial statements for the three months ended March 31, 2003 and 2002 reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. Such adjustments consist of only items of a normal recurring nature. These consolidated financial statements have not been audited by our independent certified public accountants. The operating results for the interim periods are not necessarily indicative of results for the full fiscal year.

The notes to consolidated financial statements appearing in our Annual Report on Form 10-KSB for the year ended December 31, 2002 filed with the Securities Exchange Commission should be read in conjunction with this Quarterly Report on Form 10-QSB. There have been no significant changes in the information reported in those notes other than from normal business activities.

Certain reclassifications have been made to amounts in prior periods to be consistent with the 2003 presentation.

### 2. MANAGEMENT'S ESTIMATES

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.

### 3. CONTINGENCIES

We have extended various lines of credit to Uncommon Care totaling \$4.69 million with interest rates between 10% and 12%. We have applied the guidance of EITF 99-10, specifically the percentage of ownership method, in applying the equity method to our investment in Uncommon Care. Uncommon Care's common stock equity had been eliminated by losses prior to our investment and, accordingly, we have recognized 100% of the losses of Uncommon Care, to the extent of our investment, based on our ownership of 100% of Uncommon Care's preferred stock

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equity and subordinated debt with Uncommon Care. Our total basis in investment and advances to Uncommon Care has been reduced to zero.

At March 31, 2003, Uncommon Care was not in compliance with its senior loan covenants. Uncommon Care's senior lender has several options ranging from renegotiating new loan terms to seizing collateral, thus forcing Uncommon Care into bankruptcy. Although Uncommon Care was able to secure refinance funds from a third party lender on some of its properties in April, 2003, they are still not in compliance with bank covenants and it is unknown as of the date of this report what action the lender may take. Uncommon Care's management has been informed by us that we will not advance them additional funds.

We have extended a line of credit to APS Consulting. See Note 9 to these consolidated financial statements.

We are involved in various claims and legal actions that have arisen in



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the ordinary course of business. Management believes that any liabilities arising from these actions will not have a significant adverse effect on our financial condition or results of operations.

### 4. GAIN RECOGNITION

During the three months ended March 31, 2003, we received proceeds of approximately \$49,000 and recognized a gain of \$15,000 resulting from the sale of available-for-sale equity securities.

Additionally, we recognized \$124,000 of deferred gain related to the November 2001 sale and subsequent leaseback of real estate to Prime Medical. Due to our continuing involvement in the property, we deferred recognizing approximately \$2.4 million of the approximately \$5.1 million gain and are recognizing it in earnings, as a reduction of rent expense, monthly through November 2006. In addition, 15% of the gain (\$0.76 million) related to our then 15% ownership in the purchaser, was deferred. As our ownership percentage in Prime declines through our sales of Prime common stock, we recognize these gains proportionately to our reduction of our interest in Prime. During the first three months of 2003, we recognized \$2,000 of these deferred gains.

### 5. EQUITY IN EARNINGS OF UNCONSOLIDATED AFFILIATES

At March 31, 2003 we owned approximately 4% (746,000 shares) of the outstanding common stock of Prime Medical. Our ownership percentage was reduced during 2002 when we sold 1,570,000 shares of Prime Medical common stock. As a result of our reduced ownership interest and as a result of the Company's Chairman and CEO, Kenneth S. Shifrin, stepping down from day-to-day operations as Executive Chairman of the Board of Prime Medical effective January 1, 2002, we ceased accounting for our investment in Prime Medical using the equity method effective March 19, 2002 and began accounting for our investment in Prime as an available-for-sale security in accordance with SFAS 115. Accordingly, our investment in Prime Medical is reported at fair value in our balance sheet and no equity earnings were recorded during

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### 5. EQUITY IN EARNINGS OF UNCONSOLIDATED AFFILIATES, continued

the first quarter of 2003. We recognized \$186,000 of equity earnings during the first quarter of 2002 prior to converting to the cost method of accounting for this investment.

The common stock of Prime Medical is traded in the over-the-counter market under the symbol "PMSI". Prime Medical is a Delaware corporation which is required to file with the Securities and Exchange Commission annually, quarterly and other reports and documents containing financial and other information regarding Prime Medical. Such reports and documents may be examined and copies may be obtained from the offices of the Securities and Exchange Commission.

The condensed statements of operations for Prime Medical follows (unaudited, in thousands):

Condensed statements of operations for the three months ended March 31, 2003  
and 2002

2003

2002

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	----	----
Total revenue	\$40,852	\$40,303
Income from operations	8,907	12,142
Net income	1,827	2,106

At March 31, 2003 the Company owned convertible preferred and common stock of Uncommon Care, a developer and operator of dedicated Alzheimer's care facilities. We have followed the guidance of EITF 99-10, specifically the percentage of ownership method, in applying the equity method to our investment in Uncommon Care. Uncommon Care's common stock equity had been eliminated by losses prior to our investment and, accordingly, we recognized 100% of the losses of Uncommon Care based on our ownership of 100% of its preferred stock equity and subordinated debt. During 2001 our total basis in our investment and advances to Uncommon Care was reduced to zero. Until such time as Uncommon Care becomes profitable and our future equity in these profits fully offsets our prior period combined equity losses, future advances to Uncommon Care will result in a loss when advanced.

The common and preferred shares owned by the Company, represent a 42% interest in the common equity in Uncommon Care on a fully converted basis. We continue to record our investment in and advances to Uncommon Care on the equity method.

The condensed statements of operations for Uncommon Care follows (unaudited, in thousands):

Condensed statements of operations for the three months ended March 31, 2003 and 2002

	2003	2002
	----	----
Total revenue	\$1,918	\$1,869
Income from operations	201	194
Net loss	(196)	(143)

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6. ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consists of the following:

	March 31	December 31
	2003	2002
	(Unaudited)	
	-----	-----
Commissions Payable	\$ 817,000	\$ 798,000
Taxes	113,000	93,000
Vacation	144,000	154,000
Other	190,000	182,000
	-----	-----
	\$1,264,000	\$1,227,000
	=====	=====

7. EARNINGS PER SHARE

Basic earnings per share is based on the weighted average shares

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outstanding without any dilutive effects considered. Diluted earnings per share reflect dilution from all contingently issuable shares, such as options and convertible debt. A reconciliation of earnings and average shares outstanding used in the calculation of basic and diluted earnings per share from operations follows:

	For the Three Months Ended March 31, 2003		
	Earnings (Numerator)	Shares (Denominator)	Per Share Amount
	-----	-----	-----
Earnings from operations	\$ 552,000		
Basic EPS			
Earnings available to common stockholders	552,000	2,132,000	\$0.26 =====
Diluted EPS			
Effect of dilutive securities	--	96,000	
	-----	-----	
Earnings available to common stockholders and assumed conversions	\$ 552,000 =====	2,228,000 =====	\$0.25 =====

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	For the Three Months Ended March 31, 2002		
	Earnings (Numerator)	Shares (Denominator)	Per Share Amount
	-----	-----	-----
Earnings from operations	\$ 2,602,000		
Basic EPS			
Earnings available to common stockholders	2,602,000	2,323,000	\$ 1.12 =====
Diluted EPS			
Effect of dilutive securities	--	99,000	
	-----	-----	
Earnings available to common stockholders and assumed conversions	\$ 2,602,000 =====	2,422,000 =====	\$ 1.07 =====

Unexercised employee stock options to purchase 575,000 and 456,500

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shares of the Company's common stock for the three months ended March 31, 2003 and 2002, respectively, were not included in the computations of diluted EPS because the effect would be antidilutive as their exercise price exceeds the average stock price during the period.

### 8. SEGMENT INFORMATION

The Company's segments are distinct by type of service provided. Comparative financial data for the three month periods ended March 31, 2003 and 2002 are shown as follows:

	Three months ended March 31,	
	2003	2002
	-----	-----
Operating Revenue:		
Financial services	\$4,057,000	\$3,097,000
Insurance services	2,557,000	2,109,000
Consulting	899,000	697,000
Corporate	6,000	157,000
	-----	-----
Total Segment Revenues	\$7,519,000	\$6,060,000
	=====	=====
Reconciliation to Consolidated Statement of Operations:		
Total segment revenues	\$7,519,000	\$6,060,000
Less: Intercompany dividends	--	(145,000)
Intercompany interest	(4,000)	(12,000)
	-----	-----
Total Revenues	\$7,515,000	\$5,903,000
	=====	=====

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	Three months ended March 31,	
	2003	2002
	-----	-----
Operating Income (Loss)		
Financial services	\$ 717,000	\$ 485,000
Insurance services	585,000	514,000
Consulting	273,000	67,000
Corporate	(422,000)	211,000
	-----	-----
Total segments operating profits	1,153,000	1,277,000
Gain on sale of investments	15,000	2,801,000
Profit from operations before interest, income taxes and minority interests and equity in loss of unconsolidated affiliates	1,168,000	4,078,000
Interest Income	71,000	38,000
Interest expense	1,000	18,000
Income tax expense	437,000	1,395,000
Minority interests	249,000	57,000

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Equity in loss of affiliates	--	(44,000)
	-----	-----
Net earnings	\$ 552,000	\$2,602,000
	=====	=====

### 9. SALE OF APS CONSULTING

Effective November 1, 2002, we completed the sale of APS Consulting to its management. 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%. The note is secured by the assets of APS Consulting. Our existing contract to provide 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 its remaining term.

In addition, we extended a line of credit to APS Consulting of up to \$450,000. This line is at the prime rate plus 3% and is collateralized by the accounts receivable and cash of APS Consulting. Advances under the line are dependent upon meeting borrowing base requirements.

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Under the terms of the sale agreement, we are dependent upon the future successful operation of the division to collect our proceeds from the disposal. Additionally, as we have a security interest in the assets of the division, we have retained a risk of loss on the division's assets and, under the terms of our notes with the division, we have the ability to veto certain transactions, including significant asset disposals.

Consistent with the guidance under FIN 46, we have not recognized the divestiture of APS Consulting and continue 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 occur.

Accordingly, the assets and liabilities of APS Consulting are included in our consolidated balance sheets as of March 31, 2003 and December 31, 2002. The balance sheet below summarizes the assets and liabilities of APS Consulting that are included in our consolidated balance sheet at March 31, 2003:

ASSETS	
Cash	\$226,000
Accounts Receivable, net	649,000
Prepaid Expenses	17,000
	-----
Total Current Assets	892,000
Property and Equipment	66,000
	-----

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Total Assets	\$958,000
	=====
LIABILITIES	
Accounts Payable	\$389,000
Accrued Expenses	88,000
	-----
Total Current Liabilites	477,000
Notes Payable	237,000
Federal Income Tax Payable	75,000
Deferred Income	23,000
	-----
Total Liabilites	\$812,000
	=====
Total Assets in excess of Liabilities	\$146,000
	=====

We continue to consolidate APS Consulting's revenues and expenses. If APS Consulting reports operating losses, we record such losses in our statement of operations. If APS Consulting reports net earnings, we reduce our interest in such earnings to zero by increasing the minority interest presented in our statement of operations.

Creditors of APS Consulting have no recourse to the general credit of the Company or its other consolidated subsidiaries.

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10. STOCK-BASED COMPENSATION

We have adopted the disclosure-only provisions of Statement of Accounting Standards No. 123, Accounting for Stock-Based Compensation ("SFAS 123"), as amended by SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", but measure compensation expense for our stock-based employee compensation plans using the intrinsic value method prescribed by APS Opinion No. 25, Accounting for Stock Issued to Employees. Proforma disclosures of net income and earnings per share as if the fair value-based method prescribed by SFAS 123 had been applied in measuring compensation expense follow. For purposes of the proforma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period.

	Three Months Ended March 31,	
	2003	2002
	----	----
Net Income as reported	\$552,000	\$2,602,000
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(59,000)	(59,000)
	-----	-----
Pro forma net income	493,000	2,543,000

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### Income per share

Basic - as reported	\$ 0.26	\$ 1.12
	=====	=====
Basic - pro forma	\$ 0.23	\$ 1.09
	=====	=====
Diluted - as reported	\$ 0.25	\$ 1.07
	=====	=====
Diluted - pro forma	\$ 0.22	\$ 1.05
	=====	=====

### 11. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 did not have a material effect on our consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The

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interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and did not have a material effect on our consolidated financial statements. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002.

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 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.

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

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January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. We have voluntarily elected early adoption of Interpretation No. 46. The effect of the application of this Interpretation is described in Note 9 to these consolidated financial statements.

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Item 2

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

#### FORWARD LOOKING STATEMENTS

All statements past and future, written or oral, made by the us or our officers, directors, shareholders, agents, representatives or employees, including without limitation, those statements contained in this Report on Form 10-QSB, 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. Forward-looking statements may appear in this document or other documents, reports, press releases, and written or oral presentations made by our officers to shareholders, analysts, news organizations or others. Readers should not place undue reliance on forward-looking statements. All forward-looking statements are based on information available to us and the declarant at the time the forward-looking statement is made, 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 described in such forward-looking statements. In addition to any risks and uncertainties specifically identified in connection with such forward-looking statements, the reader should consult our reports on previous filings under the Securities Act of 1933 and the Securities Exchange Act of 1934, for factors that could cause actual results to differ materially from those presented.

Forward-looking statements 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 judgements 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 control. Any such assumptions could be inaccurate and, therefore, there can be no assurance that any forward-looking statements by us or our officers, directors, shareholders, agents, representatives or employees, including those forward-looking statements contained in this Report on Form 10-QSB, will prove to be accurate.

#### CRITICAL ACCOUNTING POLICIES

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



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judgments about the carrying values of assets and liabilities

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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 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. 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 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 customer's 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.

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During 2001, it was our judgment that the equity method of accounting

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for our investment in Prime Medical and Uncommon Care was more appropriate than the cost method, on the basis that even though we held less than a 20% equity interest in Prime Medical, we had significant influence over the operational and financial policies of Prime Medical and Uncommon Care. Using the equity method we recorded our share of Prime Medical's and Uncommon Care's earnings or losses. As described earlier in the "Our other investments" section of this Form 10-KSB, during the first quarter of 2002 our sales of shares of Prime Medical common stock reduced our ownership to less than 5% of their total shares outstanding. Consequently, we stopped accounting for our investment in Prime Medical using the equity method and changed to the cost method. Unrealized gains/losses related to our investment in Prime Medical are recorded in equity as other comprehensive income, net of taxes.

In November 2002, we sold our consulting division, APS Consulting, to its management for a de minimus amount of cash and a \$250,000 seven year term note. Additionally, we retained a security interest in the assets of the division, agreed to provide continuing financial support to the division under a \$450,000 line of credit and continue to perform, for a fee, certain administrative services for the division. We determined that, under the terms of the transaction, we were dependent upon the future successful operation of the division to collect the term note receivable accepted as consideration for the sale. We further determined that we had a risk of loss in the division's assets in which we retained a security interest and, through our administrative services arrangement, maintained continuing involvement with the division.

We have accounted for the division as variable interest entity under the guidance of FIN 46 "Consolidation of Variable Interest Entities." Consistent with the guidance under FIN 46, we have not recognized the divestiture of APS Consulting and continue 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 occur.

At March 31, 2003 we owned convertible preferred and common stock of Uncommon Care, a developer and operator of dedicated Alzheimer's care facilities. We have applied the guidance of EITF 99-10, specifically the percentage of ownership method, in applying the equity method to our investment in Uncommon Care. Uncommon Care's common stock equity had been eliminated by losses prior to our investment and, accordingly, we recognized 100% of the losses of Uncommon Care based on our ownership of 100% of its preferred stock equity and subordinated debt. During 2001 our total basis in our investment and advances to Uncommon Care was reduced to zero. In 2003 it was decided that we would make no further advances to Uncommon Care due to their defaults to us and to their senior lender. While we do not intend to make any future advances to Uncommon Care, any such advances would result in our recording a loss when advanced.

### RESULTS OF OPERATIONS

#### REVENUES

Revenues from operations increased \$1,612,000 (27%) for the three month period ended March 31, 2003 compared to the same period in 2002. Revenues increased in the current three month period at all segments compared to the same period in 2002.

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Financial services revenues increased \$960,000 (31%) for the three month period ended March 31, 2003 compared to the same period in 2002. The increase in the current year three month period was due to strong commission

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revenues at APS Financial, the broker/dealer division of our financial services segment. APS Financial continues to trade predominantly in bond markets, which have been strong relative to equity markets. Commissions are higher this year as we have experienced zero turnover in broker personnel and they continue to open new institutional accounts. Also, corporate bond business volumes have been significant this year as investors look for yields above those offered by treasury securities.

Our insurance services revenues from our premium-based insurance management segment, APS Insurance Services, increased \$448,000 (21%) for the three month period ended March 31, 2003 compared to the same period in 2002. The increase is due to greater management fees and commissions, resulting from higher insurance premiums. Premiums have increased due to rate increases at the managed insurance company.

Consulting revenues increased \$202,000 (29%) for the three month period ended March 31, 2003 compared to the same period in 2002. The increase in the current year is primarily due to an increased number of short term construction and consulting projects completed during the quarter for new and existing clients. As described in Note 9 to our consolidated financial statements, we completed the sale of APS Consulting to its management effective November 1, 2002. However, since we did not satisfy the conditions to treat the sale as a divestiture, we will record operating losses of APS Consulting in our statement of operations and will record operating earnings of APS Consulting as a reduction of our interest in such earnings by increasing the minority interest presented in our statement of operations.

### EXPENSES

Total operating expenses increased \$1,736,000 (38%) for the three month period ended March 31, 2003 compared to the same period in 2002. For the current year three month period, expenses increased at our financial services, insurance services and corporate segments and decreased at our consulting segment.

Financial services expense increased \$728,000 (28%) for the three month period ended March 31, 2003 compared to the same period in 2002. The primary reason for the current year variance is a \$491,000 (30%) increase in commission expense resulting from the increase in commission revenue at APS Financial mentioned earlier. In addition, increased net profits at APS Financial resulted in a \$197,000 (162%) increase in formula driven management incentive costs.

Insurance services expenses at the insurance management subsidiary increased \$377,000 (24%) for the three month period March 31, 2003 compared to the same period in 2002. The current three month period increase is due primarily to a \$116,000 (15%) increase in commission expense paid to third party and in-house agents arising because of the aforementioned increase in commission income. Also higher this year is payroll related expenses which rose \$77,000 (13%) in the current year three month period as a result of an industry salary analysis conducted in the latter

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half of 2002 which resulted in wages within certain departments increasing to competitive levels in order to retain personnel. Lastly, management incentive expense increased \$67,000 (102%) in the current year three month period as a result of additional incentive accruals.

General and administrative expenses increased \$65,000 (18%) for the three month period March 31, 2003 compared to the same period in 2002. The

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increase in the current year period is due primarily to a 19% increase in personnel related costs, which includes annual merit raises as well as an increase in health insurance.

Gain on sale of assets for the three months ended March 31, 2003 primarily represents the recognition of deferred income resulting from reducing our investment in Prime Medical through the sale of its common stock. Approximately \$760,000 of the \$5,100,000 gain on the sale of real estate to Prime Medical in 2001 was deferred in 2001 and is to be recognized upon the reduction of our percentage in Prime Medical through the sale of its stock. To date, a total of \$517,000 of the \$760,000 originally deferred has been recognized.

Interest expense decreased \$17,000 (94%) for the three month period ended March 31, 2003 compared to the same period in 2002. The primary cause of the current period decrease is the payoff of the Company's note payable from a balance of \$2,750,000 during the first quarter of 2002. There was no long-term debt at March 31, 2003.

### GAIN ON SALE OF INVESTMENTS

The three month gain represent gains on the sale of Prime Medical common stock. As a result of these sales, as of March 31, 2003, we own approximately 746,000 shares of Prime Medical amounting to an ownership percentage of approximately 4%.

### EQUITY IN EARNINGS (LOSS) OF UNCONSOLIDATED AFFILIATES

Our equity in the earnings of Prime Medical decreased \$186,000 (100%) for the three month period ended March 31, 2003 compared to the same period in 2002 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. 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 slightly less than 5%.

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Our equity in losses of Uncommon Care decreased \$230,000 (100%) for the three month period ended March 31, 2003 compared to the same period in 2002 primarily as a result of our limiting our losses in Uncommon Care to our total investment and advances to Uncommon Care, which has been reduced to zero. Once we reduced our total investment to zero, as required under the equity method, we ceased recording equity losses. Until such time as Uncommon Care becomes profitable and future equity in these profits fully offsets our prior period combined equity losses, future advances to Uncommon Care will result in a loss when advanced. Due to Uncommon Care's default of our notes, we do not expect to make future advances to Uncommon Care.

### MINORITY INTERESTS

Minority interests represents the combination of two outside interests in subsidiaries of the Company: a twenty percent interest in Insurance Services

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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. In addition, we are now recording net income from APS Consulting as minority interest. See Note 9 to these consolidated financial statements. Minority interests increased in the current year primarily as a result of increased profitability of our insurance services segment as well as to net income from APS Consulting.

### SHAREHOLDERS' EQUITY

For the three months ended March 31, 2003, we purchased and cancelled 3,800 shares of treasury stock. These purchases and cancellations had no effect on treasury stock or common stock and decreased retained earnings by \$14,000.

Through March 31, 2003, we recorded other comprehensive loss of \$678,000 which represents unrealized holding losses on securities held for sale, primarily in Prime Medical common stock, net of tax. Changes in fair value for securities categorized as "available-for-sale" are excluded from earnings and reported net of deferred income taxes in shareholders' equity until realized.

### LIQUIDITY AND CAPITAL RESOURCES

Current assets exceeded current liabilities by \$7,134,000 at March 31, 2003 and \$6,067,000 at December 31, 2002. Working capital rose in 2003 due primarily to proceeds from the sale of non-current available-for-sale equity and fixed income securities.

Capital expenditures through the three month period ended March 31, 2003 were approximately \$58,000. Total capital expenditures are expected to be approximately \$225,000 in 2003.

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Historically, the Company has maintained a positive working capital position and has been able to satisfy its operational and capital expenditure requirements with cash generated from its 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 it is uncertain if our operating activities will continue to provide positive cash flow in 2003, we believe that our current strong working capital position will enable us to meet our working capital requirements for the foreseeable future.

### ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 did not have a material effect on our consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No.

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5, 57 and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and did not have a material effect on our consolidated financial statements. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002.

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 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.

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 have voluntarily elected early adoption of Interpretation No. 46. The effect of the application of this Interpretation is described in Note 9 to these consolidated financial statements.

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Item 3.

### CONTROLS AND PROCEDURES

- a.) Within the 90-day period prior to the date of this report, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 of the Securities and Exchange Act of 1934 (the "Exchange Act"). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to our reports (including those of our consolidated subsidiaries) required to be included in our Exchange Act filings.
- b) There have been no significant changes in our internal controls or in other factors which could significantly affect internal controls subsequent to the date we carried out our evaluation.

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PART 11

OTHER INFORMATION

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Item 1. LEGAL PROCEEDINGS

We are involved in various claims and legal actions that have arisen in the ordinary course of business. We believe that the liability provision in our consolidated financial statements is sufficient to cover any unfavorable outcome related to lawsuits in which we are currently named. Management believes that liabilities, if any, arising from these actions will not have a significant adverse effect on our financial condition or results of operations. However, due to the uncertain nature of legal proceedings, the actual outcome of these lawsuits may differ from the liability provision recorded in our consolidated financial statements.

Item 2. CHANGES IN SECURITIES

For the three months ended March 31, 2003, we purchased 3,800 and cancelled 3,800 shares of treasury stock. These purchases and cancellations had no effect on treasury stock or common stock and decreased retained earnings by \$14,000.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- 99.1 Certification of Chief Executive Officer
- 99.2 Certification of Chief Financial Officer

(b) Reports on Form 8-K.

Report filed April 18, 2003 concerning the press release reporting annual and fourth quarter 2002 results of operations and financial condition.

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Dated: May 14, 2003

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### CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF SARBANES-OXLEY ACT OF 2002

I, Kenneth S. Shifrin, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of American Physicians Service Group, Inc.

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we:

- a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
- c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

- a) all significant deficiencies in the design of operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any



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corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Kenneth S. Shifrin

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Kenneth S. Shifrin  
Chairman of the Board

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Dated: May 14, 2003

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO  
SECTION 302 OF SARBANES-OXLEY ACT OF 2002

I, William H. Hayes, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of American Physicians Service Group, Inc.
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the

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effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

- a) all significant deficiencies in the design of operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ William H. Hayes

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William H. Hayes  
Senior Vice President-Finance

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