AMERICAN PHYSICIANS SERVICE GROUP INC
Form 10-Q
August 17, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

þ Quarterly Report Pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934

For the period ended

June 30, 2007

or

¨ Transition Report Pursuant to Sections 13 or 15(d) of

the Securities and Exchange Act of 1934

For the transition period from

__________ to __________

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 of	(I.R.S. employer
incorporation or organization)	Identification No.)

1301 S. Capital of Texas Highway, Suite C-300, Austin, Texas 78746
(Address of principal executive offices)(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 Sections 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 þ No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer þ

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes ¨ No þ

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 August 1, 2007
Common Stock, $.10 par value	7,134,884

PART 1

FINANCIAL INFORMATION

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands)

	June 30, 2007	December 31, 2006
Assets		
Investments:		
Fixed maturities available for sale, at fair value	$ 188,906	$ 16,636
Equity securities available for sale, at fair value	9,731	4,403
Other invested assets	1,745	-
Total investments	**200,382**	**21,039**
Cash and cash equivalents	22,175	4,242
Cash restricted	636	1,880
Accrued investment income	1,156	197
Other amounts receivable under reinsurance contracts	2,680	-
Premium and maintenance fees receivables	16,270	-
Reinsurance recoverables on paid and unpaid loss adjustment expenses	25,854	-
Deferred policy acquisition costs	2,247	-
Management fees receivable	-	2,736
Subrogation recoverables	354	-
Deferred tax assets	7,988	1,321
Goodwill	-	1,247
Property and equipment, net	894	556
Other assets	2,741	3,058
Total assets	**$ 283,377**	**$ 36,276**

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS, continued

(Unaudited)

(in thousands)

	June 30, 2007	December 31, 2006
Liabilities		
Reserve for loss and loss adjustment expense	$ 109,816	$ -
Unearned premiums and maintenance fees	34,562	-
Reinsurance premiums payable	311	-
Funds held under reinsurance treaties	7,371	-
Trade accounts payable	6,891	2,228
Accrued expenses and other liabilities	8,360	4,323
Federal income tax payable	4,343	136
Mandatorily redeemable preferred stock	8,271	-
Total liabilities	179,925	6,687
Minority interest	22	21
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;		
6,819,384 and 2,817,746 issued and outstanding at		
06/30/07 and 12/31/06, respectively	682	282
Additional paid-in capital	73,769	7,944
Accumulated other comprehensive income (loss), net of tax	(2,692)	231
Retained earnings	31,671	21,111
Total shareholders equity	103,430	29,568
Total liabilities and shareholders equity	$ **283,377**	$ **36,276**

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
REVENUES				
Gross premiums and maintenance fees written	$ 15,045	$ -	$ 15,045	$ -
Premiums ceded	3,418	-	3,418	-
Change in unearned premiums and maintenance fees	1,983	-	1,983	-
Net premiums and maintenance fees earned	20,446	-	20,446	-
Investment income, net of investment expense	2,506	223	2,839	419
Realized capital gain (loss), net	(49)	12	(464)	20
Management service	36	3,175	3,695	6,830
Financial services	6,972	4,763	12,189	8,335
Other revenue	16	41	34	53
Total revenues	29,927	8,214	38,739	15,657
EXPENSES				
Losses and loss adjustment expenses	3,162	-	3,162	-
Other underwriting expenses	2,434	-	2,434	-
Change in deferred policy acquisition costs	157	-	157	-
Management service expenses	-	2,647	3,823	5,401
Financial services expenses	6,330	4,160	10,692	7,445
General and administrative expenses	1,421	479	2,192	998
Loss from impairment of goodwill	1,247	-	1,247	-
Total expenses	14,751	7,286	23,707	13,844
Income from operations	15,176	928	15,032	1,813

Income tax expense		5,368		329		5,319		651
Minority interests		1		1		1		2
Net income before extraordinary gain	$	9,807	$	598	$	9,712	$	1,160
Extraordinary gain, net of taxes		2,264		-		2,264		-
Net income	$	12,071	$	598	$	11,976	$	1,160

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended June 30,				Six Months Ended June 30,			
	2007		2006		2007		2006	
Net income per common share								
Basic:								
Net income before extraordinary gain	$	1.98	$	0.22	$	2.50	$	0.42
Extraordinary gain, net of taxes		0.46		-		0.58		-
Net Income	$	2.44	$	0.22	$	3.08	$	0.42
Diluted:								
Net income before extraordinary gain	$	1.93	$	0.21	$	2.41	$	0.40
Extraordinary gain, net of taxes		0.44		-		0.56		-
Net Income	$	2.37	$	0.21	$	2.97	$	0.40
Basic weighted average shares outstanding		4,955		2,762		3,894		2,762
Diluted weighted average shares outstanding		5,091		2,917		4,026		2,936

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(in thousands, except per share amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income (loss)	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total Shareholders Equity
Balance December 31, 2006	$ 282	$ 7,944	$ 21,111	$ --	$ 231	$ --	$ 29,568
Comprehensive income:							
Net income (loss)	--	--	(95)	(95)	--	--	(95)
Other comprehensive income:							
Unrealized loss on securities, net of taxes of ($25)	--	--	--	(48)	(48)	--	(48)
Comprehensive income:	$ --	$ --	$ --	$ (143)	$ --	$ --	$ --
Stock options exercised	1	79	--	--	--	--	80
Stock options expensed	--	915	--	--	--	--	915
Tax benefit from exercise of							
Stock options	--	71	--	--	--	--	71
Treasury stock purchases	--	--	--	--	--	(37)	(37)
Canceled treasury stock	--	(37)	--	--	--	37	-
Stock awarded	3	460	--	--	--	--	463
Balance March 31, 2007	$ 286	$ 9,432	$ 21,016	$ --	$ 183	$ --	$ 30,917

Comprehensive income:							
Net income (loss)	--	--	12,071	12,071	--	--	12,071
Other comprehensive income:							
Unrealized loss on securities, net of taxes of ($1,481)	--	--	--	(2,875)	(2,875)	--	(2,875)
Comprehensive income:	$ --	$ --	$ --	$ 9,196	$ --	$ --	$ --
Stock options exercised	1	52	--	--	--	--	53
Stock options expensed	--	103	--	--	--	--	103
Tax benefit from exercise of stock options	--	11	--	--	--	--	11
Treasury stock purchases	--	--	--	--	--	(539)	(539)
Canceled treasury stock	(3)	(536)	--	--	--	539	--
Stock issued-Public Offering, net of offering costs of $783,000	200	30,037	--	--	--	--	30,237
Stock issued-Merger	198	34,670	--	--	--	--	34,868
Dividend paid	--	--	(1,416)	--	--	--	(1,416)
Balance June 30, 2007	$ 682	$ 73,769	$ 31,671	$ --	$ (2,692)	$ --	$ 103,430

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

Cash flows from operating activities:	**Six Months Ended June 30,**	
	2007	**2006**
Net Income	$ 11,976	$ 1,160
Adjustments to reconcile net income to cash provided by (used in)		
operating activities:		
Depreciation, amortization and other	228	364
Common stock awarded	1,000	102
Extraordinary gain	(2,264)	-
Impairment of assets	1,892	-
Deferred income tax	(2,220)	261
Other non-cash items	(82)	43
Changes in operating assets and liabilities:		
Premium receivables, net	(1,623)	-
Other amounts receivable under reinsurance contracts	(1,307)	-
Reinsurance recoverables on unpaid and paid loss expenses	3,831	-
Funds held under reinsurance treaties	(3,741)	-
Losses and loss adjustment expenses	(6,411)	-
Unearned premiums and maintenance fees	(1,954)	-
Other receivables and assets	5,634	1,712
Federal income tax payable	2,025	(690)
Deferred compensation	563	22
Accrued expenses and other liabilities	4,023	(1,353)
Net cash provided by operating activities	11,570	1,621
Cash flows from investing activities:		
Capital expenditures	(469)	(103)
Proceeds from the sale of available-for-sale equity	20,903	4,760
Purchase of available-for-sale equity securities	(51,159)	(4,988)
Funds loaned to others	(275)	(248)
Cash received from API acquisition	9,910	-
Collection of notes receivable	26	10
Net cash used in investing activities	(21,064)	(569)
Cash flows from financing activities:		
Secondary stock offering	30,237	-
Exercise of stock options	118	504

Excess tax benefits from stock-based compensation		82		355
Treasury stock purchases		(576)		(1,991)
Dividends paid		(1,416)		(820)
Preferred stock redemption		(1,018)		-
Net cash provided by (used in) financing activities		27,427		(1,952)
Net change in cash and cash equivalents	$	17,933	$	(900)
Cash and cash equivalents at beginning of period		4,242		6,680
Cash and cash equivalents at end of period	$	22,175	$	5,780

The accompanying notes are an integral part of these condensed consolidated financial statements.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

1.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The consolidated unaudited financial statements as of and for the three- and six-month periods ended June 30, 2007 and 2006 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 registered public accounting firm. 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-K for the year ended December 31, 2006 filed with the SEC should be read in conjunction with this Quarterly Report on Form 10-Q. There have been significant changes in the type of information reported and the presentation format in this Quarterly Report as a result of the acquisition of American Physicians Insurance Company (API) effective April 1, 2007 and such changes are disclosed in the notes hereto.

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.

The most significant estimates that are susceptible to significant change in the near-term relate to the determination of the liability for reserves for losses and loss adjustment expense, reinsurance, income taxes, and the fair value of investments. Although considerable judgment is inherent in these estimates, management believes that the current estimates are reasonable in all material respects. The estimates are reviewed regularly and adjusted, as necessary. Adjustments related to changes in estimates are reflected in the Company s results of operations, or other comprehensive income, in the period in which those estimates are changed.

3.

Acquisition

On April 1, 2007, we acquired all of the issued and outstanding stock of API. We considered several factors in determining to acquire API, including the favorable effects tort reform had on the Texas market, our long-term experience managing API s operations, our credibility in the marketplace, the common goals we shared with API s board of directors, the ability to increase API s capital to support future growth after the acquisition and the increased financial strength of the combined entity. The results of operations for API are included in our consolidated results of operations beginning April 1, 2007. The business combination is being accounted for using the purchase method of accounting and, accordingly, the purchase price has been allocated to assets acquired and liabilities assumed based on fair values at the date of acquisition. The allocation has been reviewed but not audited by our outside auditors and will not be final until the audit of the 2007 financial results. The total purchase price was $45,167,000 and consisted of 1,982,499 shares of the Company s common stock, valued at a per share price of $17.635, or $34,961,000 in the aggregate, $35,000 in cash paid in lieu of fractional shares of common stock, 10,197.95 shares of preferred stock valued at $9,179,000, plus costs to complete the acquisition of $992,000. We are required to redeem at least $1 million of the preferred stock each calendar year beginning in 2007, until December 31, 2016, at which time all of the preferred stock must have been redeemed. The preferred stock has a cumulative dividend equal to 3% of the outstanding redemption value per year. On June 1, 2007 we made the first required payment, redeeming 10% of the preferred shares outstanding and paying the dividend. The following table discloses the amount assigned to each major asset and liability of API at the acquisition date, April 1, 2007.

The purchase price was allocated to the balance sheet of API as of April 1, 2007, as follows:

(in thousands)	
ASSETS	
Investments:	
Fixed maturities available for sale	$ 145,354
Equity securities available for sale	6,851
Other invested assets	1,848
Total investments	154,053
Cash and cash equivalents	9,910
Accrued investment income	793
Premium and maintenance fees receivable	14,647
Other amounts receivable under reinsurance recoverables	1,373
Reinsurance recoverables on paid and unpaid loss adjustment expenses	29,685
Prepaid reinsurance premiums	311
Deferred policy acquisition costs	2,404
Deferred tax assets	4,630
Subrogation recoverables	505
Other assets	358
Total assets	**$ 218,669**
LIABILITIES AND SHAREHOLDERS EQUITY	
Liabilities	
Reserve for losses and loss adjustment expenses	116,227
Unearned premiums and maintenance fees	36,516
Reinsurance premiums payable	253
Funds held under reinsurance treaties	11,112
Federal income tax payable	2,623
Other liabilities	4,507
Total liabilities	**$ 171,238**

Purchase Price	45,167
Excess of net assets received over cost to acquire (1)	2,264
Total	**$ 218,669**

(1)

The fair value of net assets acquired exceeded the cost of acquisition. After review it was determined that no intangibles were acquired and that no assets should be reduced below their carrying value, which approximates fair value. Consequently, an extraordinary gain of $2,264,000 was recognized in the period of the acquisition in accordance with SFAS No. 141, *Accounting for Business Combinations*.

The tables below reflect the unaudited pro forma balance sheet as of December 31, 2006, and the results of operations for the three- and six-month periods ended June 30, 2007 and 2006 of the Company and API as if the acquisition had taken place on January 1 of 2007 and 2006, respectively, including estimated purchase accounting adjustments.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

PRO FORMA CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands)

		December 31, 2006
Assets		
Investments:		
Fixed maturities available for sale, at fair value	$	148,587
Equity securities available for sale, at fair value		11,111
Other invested assets		1,647
Total investments		161,345
Cash and cash equivalents		8,990
Cash restricted		1,880
Accrued investment income		706
Premium and maintenance fees receivable		16,493
Reinsurance recoverables on paid and unpaid loss adjustments		28,491
Deferred policy acquisition costs		2,545
Management fees and other receivables		9,488
Subrogation recoverables		509
Deferred tax assets		5,577
Property and equipment, net		556
Other assets		2,625
Total assets	**$**	**239,205**

AMERICAN PHYSICIANS SERVICE GROUP, INC.

PRO FORMA CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands)

		December 31, 2006
Liabilities		
Reserve for losses and loss adjustment expenses	$	110,089
Unearned premiums and maintenance fees		39,786
Reinsurance premiums payable		45
Funds held under reinsurance treaties		4,003
Trade accounts payable		2,228
Accrued expenses and other liabilities		9,457
Federal income tax payable		650
Mandatorily redeemable preferred stock		9,179
Total liabilities		175,437
Minority interest		21
Shareholders equity		
Common stock		480
Additional paid-in capital		42,707
Accumulated other comprehensive income, net of tax		633
Retained earnings		19,927
Total shareholders equity		63,747
Total liabilities and shareholders equity	$	**239,205**

AMERICAN PHYSICIANS SERVICE GROUP, INC.

PRO FORMA CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
REVENUES				
Gross premiums and maintenance fees written	$ 15,045	$ 17,324	$ 30,511	$ 37,439
Premiums ceded	3,418	522	1,011	(2,255)
Change in unearned premiums and maintenance fees	1,983	1,845	5,235	2,138
Net premiums and maintenance fees earned	20,446	19,691	36,757	37,322
Investment income, net of investment expense	2,506	1,842	4,666	3,548
Realized capital gains (loss), net	(49)	34	(257)	143
Management services	36	-	36	-
Financial services	6,972	4,662	11,882	8,119
Other revenue	16	88	49	189
Total revenues	29,927	26,317	53,133	49,321
EXPENSES				
Losses and loss adjustment expenses	3,162	6,572	14,126	18,222
Other underwriting expenses	2,434	2,241	5,791	4,880
Change in deferred policy acquisition costs	157	109	298	71
Financial services expenses	6,330	4,158	10,767	7,443
General and administrative	1,421	1,724	2,326	2,133
Loss from impairment of goodwill	1,247	1,247	1,247	1,247
Total expenses	14,751	16,051	34,555	33,996
Income from operations	15,176	10,266	18,578	15,325

Income tax expense		5,368		3,708		6,511		5,224
Minority interests		1		1		2		2
Net income before extraordinary gain	$	9,807	$	6,557	$	12,065	$	10,099
Extraordinary gain		2,264		-		2,264		-
Net income	$	12,071	$	6,557	$	14,329	$	10,099

4.

Impairment of Goodwill

Goodwill arose with the re-purchase of an interest in one of our subsidiaries, APS Insurance Services, from the minority holder in 2003. Goodwill was determined to exist based on earnings expected to be generated from the management contract with API. With the purchase of API by us and termination of the management agreement, the question of impairment of the goodwill was raised. Upon review, we determined that the original circumstances creating the goodwill no longer exist and that the entire $1,247,000 balance is impaired and should be written down.

5.

Investments

Available-For-Sale Fixed Maturities. Of the total $188,906,000 portfolio balance in available-for-sale fixed income maturities at June 30, 2007, all but $701,000 is considered investment grade securities. Our investment strategy is reviewed and approved by our board of directors annually. The primary goal of our investment strategy for our insurance services segment is to ensure that we have sufficient assets to meet our obligations to our policyholders, and our secondary goal is to provide investment income. The investment plan for our insurance services segment provides guidance on diversification, duration of the portfolio, sector allocation and specific restrictions, such as the size of investment in any one issue and limitations on the purchases of securities rated lower than A by Moody s, Standard and Poor s or a comparable rating institution.

Our insurance services segment employs an investment strategy that emphasizes asset quality to minimize the credit risk of our investment portfolio and also matches fixed-income maturities to anticipated claim payments and expenditures or other liabilities. The amounts and types of investments that may be made by our insurance services segment are regulated under the Texas Insurance Code. We utilize APS Financial, our broker/dealer subsidiary, as our fixed-income advisor and also utilize two outside managers to manage our equity portfolio. Our boards of directors review our investment managers performance and compliance with our investment guidelines on a quarterly basis.

Virtually our entire fixed-income portfolio consists of securities rated A or higher from any of Standard and Poor s, Moody s or Fitch with the exception of two bonds totaling approximately $701,000. The following table reflects the composition of our fixed-income portfolios by securities ratings categories of the issuers, as of June 30, 2007 (dollars in thousands). In cases where the rating agencies had a different rating assigned to a security, the classification in the table used the lower rating.

Rating Category	**Fair Value**	**Percentage**
AAA / Aaa	$ 165,031	88%
AA / Aa	9,983	5%
A / A	13,191	7%
Non-investment grade	701	-
Total	$ 188,906	100%

We account for our fixed-income and equity securities as available-for-sale. The majority of unrealized losses on the bonds was caused by increases in market interest rates and is not due to changes in the credit worthiness of the issuer. Virtually all bonds with an unrealized loss over 12 months or more are investment grade securities.

Available-For-Sale Equity Securities. Our equity portfolio consists of $9,731,000 in available-for-sale equity securities, comprising 4.9% of total investments at market value as of June 30, 2007. The majority of unrealized losses related to stocks are due to market fluctuations resulting from cyclical and other economic pressures. We believe that these unrealized losses are temporary and that the fair value will recover to a level equal to or greater than our cost basis. An additional impairment charge was taken in the current quarter on our investment in Financial Industries Corporation (FIC) having previously resolved that declines in FIC s stock price will be considered to be other than temporary as defined in Statements of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended. Our policy in regards to our investment in FIC is that we will record pretax charges to earnings should the common stock price on the last day of each interim or annual period fall below the adjusted cost basis of our investment in FIC. During the three months ended June 30, 2007, that charge totaled $231,000, bringing the total amount written off in 2007 to $655,000. As a consequence of these write-downs, our basis in this stock has declined to $5.90 per share which equals the fair market value of FIC common stock at June 30, 2007. While we continue to have the ability and the intent to hold the stock indefinitely, we previously determined that the additional uncertainty created by FIC s previous late SEC filings, together with its continued de-listing from any national stock exchanges, dictated that the current quarter decline should be viewed as other than temporary. We will continue to monitor and evaluate the situation at FIC.

The amortized cost and estimated fair values of investments in fixed income and equity securities at June 30, 2007 and December 31, 2006 are as follows (in thousands):

June 30, 2007	**Cost or Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Fixed maturities:				
U.S. treasury notes/bills	$ 9,366	$ 4	$ 62	$ 9,308
U.S. government agency mortgage-backed bonds	34,558	-	807	33,751
U.S. government agency collateralized mortgage obligations	53,361	3	1,269	52,095
Collateralized mortgage obligations	56,267	4	1,961	54,310
U.S. agency bonds and notes	21,076	4	17	21,063
Government tax-exempt bonds	16,001	-	440	15,561
Corporate bonds	2,872	14	68	2,818
Total fixed maturities	193,501	29	4,624	188,906
Equity securities	9,482	386	137	9,731
Total fixed maturities and equity securities	$ 202,983	$ 415	$ 4,761	$ 198,637

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December 31, 2006	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S. treasury notes/bills	$ 1,999	$ -	$ 5	$ 1,994
U.S. government agency collateralized mortgage obligations	180	10	-	190
U.S. agency bonds and notes	13,755	1	14	13,742
Corporate bonds	682	28	-	710
Total fixed maturities	16,616	39	19	16,636
Equity securities	4,073	330	-	4,403
Total fixed maturities and equity securities	$ 20,689	$ 369	$ 19	$ 21,039

The securities acquired as part of API were revalued to market value as of the date of the merger, April 1, 2007. For June 30, 2007 the unrealized losses in fixed maturity and equity investments increased to $4,761,000 primarily as a result of rising interest rates. The fixed maturity investments are virtually all investment grade securities. We have the ability and intent to hold securities with unrealized losses until they recover their value, which may be at maturity. As of June 30, 2007, and December 31, 2006, the only impairment in value resulting in a write-down against income involved our equity investment in FIC, explained in more detail on the prior page. In the future, information may come to light or circumstances may change that would cause us to write-down or sell any of our fixed maturity or equity securities and incur a realized loss.

Gross realized gains and losses on fixed maturity and equity securities included in the statement of operations for the three and six months ended June 30, 2007 and 2006 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Realized gains (losses)				
Fixed maturities:				
Gross realized gain	$ 4	$ -	$ 3	$ 7
Gross realized loss	(4)	(1)	(4)	0
Net realized gain (loss)	(0)	(1)	(1)	7

Equities:								
Gross realized gain		260		13		270		13
Gross realized loss		(309)		-		(733)		-
Net realized gain (loss)		(49)		13		(463)		13
Total net realized gain (loss)	$	(49)	$	12	$	(464)	$	20

The major categories of the net investment income included in the statement operations are summarized for the three and six months ended June 30, 2007 and 2006, as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Investment income:				
Fixed maturities	$ 2,307	$ 158	$ 2,523	$ 302
Equity securities	40	6	49	12
Short-term investments and other	181	59	289	105
Finance charges on premiums receivable	28		28	
Structured annuity	20		20	
Total investment income	2,576	223	2,909	419
Investment expense	(70)		(70)	
Net investment income	$ 2,506	$ 223	$ 2,839	$ 419

In accordance with SFAS No. 115, *Accounting for Certain Investments In Debt and Equity Securities*, we evaluate our investment securities on at least a quarterly basis for declines in market value below cost for the purpose of determining whether these declines represent other than temporary declines. A decline in the fair value of a security below cost judged to be other than temporary is recognized as a loss in the current period and reduces the cost basis of the security. In subsequent periods, we would measure gain or losses or decline in value against the adjusted cost basis of the security. The following factors are considered in determining whether an investment decline is other than temporary :

- The extent to which the market value of the security is less than its cost basis,
- The length of time for which the market value of the security is less than its cost basis,
- The financial condition and near-term prospects of the security s issuer, taking into consideration the economic prospects of the issuer s industry and geographical region, to the extent that information is publicly available and

- Our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

The following two tables reflect securities whose fair values were lower than the related cost basis at June 30, 2007 and December 31, 2006, respectively (in thousands). However, these declines in value were not deemed to be other than temporary . The tables show the fair value and the unrealized losses, aggregated by investment category and category of duration that individual securities have been in a continuous unrealized loss position. For the first six months ended June 30, 2007 and for the year end December 31, 2006, the only impairment in value resulting in a write-down against income involved our equity investment in FIC, explained in more detail on page 16.

June 30, 2007:	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
U.S. treasury notes/bills	$ 3,356	$ 62	$ 1,000	$	$ 4,356	$ 62
U.S. government agency mortgage-backed bonds	30,301	807			30,301	807
U.S. government agency collateralized mortgage obligations	48,040	1,259	3,030	10	51,070	1,269
Collateralized mortgage obligations	51,800	1,961			51,800	1,961
U.S. agency bonds and notes	12,911	16	2,465	1	15,376	17
Government tax-exempt bonds	15,561	440			15,561	440
Corporate bonds	2,117	68			2,117	68
Total Bonds	164,086	4,613	6,495	11	170,581	4,624
Equity Securities	2,698	93	470	44	3,168	137
Total temporarily impaired securities	$ 166,784	$ 4,706	$ 6,965	$ 55	$ 173,749	$ 4,761

December 31, 2006:	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
U.S. treasury notes/bills	$ 1,995	$ 5	$	$	$ 1,995	$ 5
U.S. agency bonds and notes	9,459	12	991	2	10,450	14
Total Bonds	11,454	17	991	2	12,445	19
Equity Securities			332		332	

Total temporarily impaired securities	$	11,454	$	17	$	1,323	$	2	$	12,777	$	19

The majority of the unrealized losses on the fixed maturities were caused by increases in market interest rates and not due to changes in the credit worthiness of the issuer. All fixed maturities with an unrealized loss over 12 months or more are investment grade securities. The majority of the unrealized losses related to stocks are due to market fluctuations resulting from cyclical and other economic pressures. As of June 30, 2007, we believe that these unrealized losses are temporary and that the fair value will recover to a level equal to or greater than the cost basis. In addition, as of June 30, 2007, we had the ability and intent to hold these investments until there is a recovery in fair value, which may be maturity for the applicable securities.

As a result of our acquisition of API, the Texas Department of Insurance (TDI) required that funds be set aside in an escrow account with a bank to remain until the aggregate remaining redemption obligation of our Series A redeemable preferred stock is less than the amount of the escrow balance, with no withdrawals to be made from this escrow account without prior approval from TDI. To satisfy this condition of the merger, we purchased a fixed income security in March of 2007 in the amount of $2,500,000 paying 5% interest and maturing in March of 2008 and this security is included in fixed maturities, available for sale.

At June 30, 2007 investments with a fair market value of $1,321,900 were on deposit with state insurance departments to satisfy regulatory requirements and this security is included in fixed maturities, available for sale.

6.

<u>Cash -- Restricted</u>

Cash Restricted represents cash deposits advanced from customers for trade claim transactions that do not close by the end of the period. It occurs when a customer remits payment for a transaction by check instead of via wire transfer. As checks of this size normally take several business days to clear, we ask our customers to pay in advance for transactions expected to close in the near future. At the time of receipt, Cash Restricted and Accounts Payable are increased for an equal amount as no part of this cash is ours until the transaction closes.

7.

<u>Reinsurance</u>

<u>Reinsurance Premiums Ceded</u>. Certain premiums are ceded to other insurance companies under reinsurance agreements. These reinsurance agreements provide us with increased capacity to write additional risk and the ability to write specific risk within its capital resources and underwriting guidelines. API enters into reinsurance contracts, which provide coverage for losses in excess of the retention of $250,000 on individual claims and beginning in 2002 through 2005, $350,000 on multiple insured claims related to a single occurrence. The 2006 and 2007 reinsurance treaties provide for these same terms with API retaining an additional 10% of the aforementioned retention levels for 2006 and 20% for 2007. The reinsurance contracts for 2002 through 2007 contain variable premium ceding rates based on loss experience. The ceded premium charged under these contracts will depend upon the development of ultimate losses ceded to the reinsurers under their retrospective treaties. For the quarter ended June 30, 2007, we recorded favorable development to ceded premiums of $5,636,000 related to prior year variable premium reinsurance treaties as a result of lower estimated ultimate loss and loss adjustment expenses for treaty years 2002 through 2006. The favorable development reflects reductions in our estimates of claim severity as a result of claim closures at less than reserved amounts.

In addition to an adjustment to premiums ceded, estimates of ultimate reinsurance ceded premium amounts compared to the amounts paid on a provisional basis give rise to a balance sheet asset classified as Other amounts receivable under reinsurance contracts or a balance sheet liability classified as Funds held under reinsurance treaties. Furthermore, each retrospective treaty requires a 24- or 36-month holding period before any premium adjustments or cash can be returned or paid. The ultimate settlement amount is not determined until all losses have been settled under the respective treaties. As of June 30, 2007, API had recorded a balance sheet asset, Other amounts receivable under reinsurance contracts of $2,680,000 and a balance sheet liability, Funds held under reinsurance treaties of $7,371,000, which represent the differences between the estimates of ultimate reinsurance premiums ceded amounts for the 2002 through 2007 treaty years as compared to the amounts paid on a provisional basis.

<u>Reinsurance Recoverables</u>. Ceded reserves for loss and loss adjustment expenses are recorded as reinsurance recoverables. Reinsurance recoverables are the estimated amount of future loss payments that will be recovered from reinsurers, and represent the portion of losses incurred during the period that are estimated to be allocable to reinsurers. There are several factors that can directly affect the ability to accurately forecast the reinsurance recoverables. Many of the factors discussed in Note 8 related to the sensitivities of forecasting total loss and loss adjustment expense reserves also apply when analyzing reinsurance recoverables. Since API cedes excess losses above $250,000 on individual claims and $350,000 on multiple insured claims, the trends related to severity significantly affect this estimate. Current individual claims severity can be above or fall below API s retention level over the period it takes to resolve a claim.

Similar to the estimate for reserves, due to the long-tailed nature of the medical professional liability line of insurance, relatively small changes in the actuarial assumptions for trends, inflation, severity, frequency for projected ultimate loss and loss adjustment expense reserves can have a greater impact on the recorded balance for reinsurance recoverables than with most other property and casualty insurance lines. While we believe that our estimate for ultimate projected losses related to loss and loss adjustment expense is adequate based on reported and open claim counts, there can be no assurance that additional significant reserve enhancements will not be necessary in the future given the many variables inherent in such estimates and the extended period of time that it can take for claim patterns to emerge.

Reinsurance contracts do not relieve API from its obligations to policyholders. API continually monitors its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Any amount found to be uncollectible is written off in the period in which the uncollectible amount is identified. API requires letters of credit from any reinsurance company that does not meet certain regulatory requirements, and/or credit ratings. As of June 30, 2007, all of API s reinsurance contracts were with companies in strong financial condition, and we believe there is no need to establish an allowance for uncollectible reinsurance recoverable. API has not experienced any material problems collecting from its reinsurers.

Unsecured reinsurance recoverables at June 30, 2007, that exceeded 10% of total reinsurance paid and unpaid loss and loss adjustment expenses are summarized as follows (in thousands):

Company Name		**June 30, 2007**
Transatlantic Reinsurance	$	4,652
Swiss Reinsurance		14,814

Both Transatlantic Reinsurance and Swiss Reinsurance are A.M. Best rated A+ (Superior).

8.

Reserve for Loss and Loss Adjustment Expense

The reserve for unpaid losses and loss adjustment expenses represent the estimated liability for unpaid claims reported to the Company, plus claims incurred but not reported and the related estimated loss adjustment expenses. The reserve for losses and loss adjustment expenses is determined based on our actual experience, available industry data and projections as to future claims frequency, severity, inflationary trends and settlement patterns.

We write medical malpractice insurance policies which have a lengthy period for reporting a claim (tail coverage) and a long process of litigating a claim through the courts and whose risk factors expose its reserves for loss and loss adjustment expenses to significant variability. These conditions subject API s open reported claims and incurred but not reported claims to increases due to inflation, changes in legal proceedings, and changes in the law. While the anticipated affects of inflation is implicitly considered when estimating reserves for loss and loss adjustment expenses, the increase in average severity of claims is caused by a number of factors. Future average severities are projected based on historical trends adjusted for changes in underwriting standards, policy provisions, and general economic trends. Those anticipated trends are monitored based on actual experience and are modified as necessary to reflect any changes in the development of ultimate losses and loss adjustment expenses. These specific risks, combined with the variability that is inherent in any reserve estimate, could result in significant adverse deviation from our carried reserve amounts. Settlement of claims is subject to considerable uncertainty. We believe the reserves for loss and loss adjustment expenses are reasonably stated as of June 30, 2007.

As a result of the acquisition of API on April 1, 2007, we recorded $3,162,000 for losses and loss adjustment expenses for the three months and the six months ended June 30, 2007, which included $11,661,000 for the current accident year and $8,499,000 of favorable development for prior report years. The $8,499,000 of favorable development was primarily the result of loss severity for the 2002 through 2006 report years developing favorably compared to prior period estimates. In addition, the total number of claims closed with indemnity for these report years were less than prior estimates.

9.

Contingencies

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

10.

Earnings Per Share

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

	For the Three Months Ended June 30, 2007				
		Income (Numerator)	Shares (Denominator)		Per Share Amount
Net income before extraordinary gain	$	9,807,000			
Extraordinary gain, net of tax		2,264,000			
Basic EPS:					
Net income	$	12,071,000	4,955,000	$	2.44
Effect of dilutive securities		--	136,000		
Diluted EPS:					
Net income	$	12,071,000	5,091,000	$	2.37

	For the Three Months Ended June 30, 2006				
		Income (Numerator)	Shares (Denominator)		Per Share Amount
Basic EPS:					
Net income	$	598,000	2,762,000	$	0.22
Diluted EPS:		--	155,000		
Effect of dilutive securities					
Net income	$	598,000	2,917,000	$	0.21

	For the Six Months Ended June 30, 2007		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income before extraordinary gain	$ 9,712,000		
Extraordinary gain, net of tax	2,264,000		
Basic EPS:			
Net income	$ 11,976,000	3,894,000	$ 3.08
Effect of dilutive securities	--	132,000	
Diluted EPS:			
Net income	$ 11,976,000	4,026,000	$ 2.97

	For the Six Months Ended June 30, 2006		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS:			
Net income	$ 1,160,000	2,762,000	$ 0.42
Diluted EPS:	--	174,000	
Effect of dilutive securities			
Net income	$ 1,160,000	2,936,000	$ 0.40

11.

Segment Information

The Company s segments are distinct by type of service provided. Comparative financial data for the three- and six-month periods ended June 30, 2007 and 2006 are shown as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Operating revenue:				
Insurance services	$ 22,842	$ 3,175	$ 26,499	$ 6,830
Financial services	7,051	4,804	12,363	8,403
Corporate				