

AMERICAN PHYSICIANS SERVICE GROUP INC

Form 10-Q

August 09, 2005

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934
FOR THE PERIOD ENDED JUNE 30, 2005

OR

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

TO

COMMISSION FILE NUMBER 0-11453

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 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 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 | JULY 20, 2005 |
|-------------------------------|------------------------------------|---------------|
| ----- | | ----- |
| Common Stock, \$.10 par value | | 2,677,233 |

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PART I

FINANCIAL INFORMATION

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

(In thousands, except per share data)

Item 1 - Financial Statements

| | Three Months Ended June 30, | |
|--|--------------------------------|---------|
| | 2005 | 2004 |
| | ----- | ----- |
| Revenues: | | |
| Financial services | \$3,698 | \$4,227 |
| Insurance services | 3,335 | 3,068 |
| | ----- | ----- |
| Total revenues | 7,033 | 7,295 |
| Expenses: | | |
| Financial services | 3,270 | 3,660 |
| Insurance services | 2,422 | 2,380 |
| General and administrative | 722 | 555 |
| Gain on sale of assets (Note 4) | (49) | (44) |
| | ----- | ----- |
| Total expenses | 6,365 | 6,551 |
| | ----- | ----- |
| Operating income | 668 | 744 |
| Gain on sale of investments (Note 5) | 1,346 | 218 |
| Loss on impairment of investment (Note 6) | (57) | - |
| Gain on extinguishment of debt (Note 7) | - | 12 |
| | ----- | ----- |
| Income from continuing operations before interest, income taxes and minority interest | 1,957 | 974 |
| Interest income | 125 | 72 |
| Other income | 29 | 26 |
| Interest expense | - | 2 |
| Income tax expense | 742 | 381 |
| Minority interests | 2 | - |

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| | | |
|------------|---------|-------|
| | ----- | ----- |
| Net income | \$1,367 | \$689 |
| | ===== | ===== |

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

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

(In thousands, except per share amounts)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|---------------|------------------------------|---------------|
| | ----- 2005 | ----- 2004 | ----- 2005 | ----- 2004 |
| Net income per common share | | | | |
| Basic: | | | | |
| Income from operations | \$ 0.51 | \$ 0.28 | \$ 0.84 | \$ 0.56 |
| | ---- | ---- | ---- | ---- |
| Net income | \$ 0.51 | \$ 0.28 | \$ 0.84 | \$ 0.56 |
| | ===== | ===== | ===== | ===== |
| Diluted: | | | | |
| Income from operations | \$ 0.48 | \$ 0.25 | \$ 0.77 | \$ 0.49 |
| | ---- | ---- | ---- | ---- |
| Net income | \$ 0.48 | \$ 0.25 | \$ 0.77 | \$ 0.49 |
| | ===== | ===== | ===== | ===== |
| Basic weighted average shares outstanding | 2,656 | 2,505 | 2,649 | 2,489 |
| | ===== | ===== | ===== | ===== |
| Diluted weighted average shares outstanding | 2,876 | 2,791 | 2,892 | 2,802 |
| | ===== | ===== | ===== | ===== |

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

(In thousands)

| | June 30, 2005 |
|---|------------------|
| | ----- |
| ASSETS | |
| Current Assets: | |
| Cash and cash equivalents | \$6,059 |
| Trade receivables, net | 8 |
| Notes receivable - current | 1,072 |
| Management fees and other receivables | 917 |
| Deposit with clearing organization | 660 |
| Investment in available-for-sale fixed income securities - current | 5,451 |
| Net deferred income tax asset | 112 |
| Income tax receivable | 69 |
| Prepaid expenses and other | 777 |
| | ----- |
| Total current assets | 15,125 |
| Notes receivable, less current portion | 338 |
| Property and equipment, net | 686 |
| Investment in available-for-sale equity securities (Notes 5 and 8) | 7,558 |
| Investment in available-for-sale fixed income securities - non-current | 3,643 |
| Goodwill | 1,247 |
| Other assets | 267 |
| | ----- |
| Total Assets | \$28,864 |
| | ===== |

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

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

(In thousands, except share data)

June 30,

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2005

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:

| | |
|--|-------|
| Accounts payable | \$226 |
| Accrued incentive compensation | 846 |
| Accrued expenses and other liabilities (Note 10) | 1,179 |
| Deferred gain - current | 488 |
| | ----- |
| Total current liabilities | 2,739 |

| | |
|---|-------|
| Payable under loan participation agreements | 24 |
| Deferred tax liability - non-current | 15 |
| Deferred gain - non-current | 305 |
| | ----- |
| Total liabilities | 3,083 |

| | |
|--|----|
| Minority interests | 14 |
| Commitments and contingencies (Note 3) | |

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; 2,677,233 and 2,646,646 issued and outstanding at 06/30/05 and 12/31/04, respectively | 268 |
| Additional paid-in capital | 7,695 |
| Retained earnings | 16,168 |
| Accumulated other comprehensive income, net of taxes | 1,636 |
| | ----- |
| Total shareholders' equity | 25,767 |
| | ----- |

| | |
|--|----------|
| Total Liabilities and Shareholders' Equity | \$28,864 |
| | ===== |

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

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

Six Mo

2005

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Cash flows from operating activities:

| | |
|---|-----------|
| Net Income | \$ 2,22 |
| Adjustments to reconcile net income to cash used in operating activities: | |
| Depreciation and amortization | 16 |
| Extinguishment of debt and other | 13 |
| Common stock awarded | 15 |
| Gain on sale of assets | (8) |
| Deferred gain on sale of building | (24) |
| Gain on sale of investment | (1,97) |
| Impairment of investment | 9 |
| Changes in operating assets and liabilities: | |
| Trade receivables | 1 |
| Trading account securities | - |
| Income tax receivable | (5) |
| Deferred income tax | (22) |
| Receivable from clearing organization | - |
| Management fees & other receivables | 89 |
| Prepaid expenses & other assets | (13) |
| Trade payables | (4) |
| Accrued expenses & other liabilities | (2,09) |
| Net cash used in operating activities | (1,16) |
| | |
| Cash flows from investing activities: | |
| Capital expenditures | (17) |
| Proceeds from the sale of available-for-sale equity and fixed income securities | 4,17 |
| Purchase of available-for-sale equity securities | (5,28) |
| Funds loaned to others | (77) |
| Collection of notes receivable | 14 |
| Net cash used in investing activities | (1,90) |
| | |
| Cash flows from financing activities: | |
| Exercise of stock options | 56 |
| Purchase and cancellation of treasury stock | (1,11) |
| Net cash provided by (used in) financing activities | (54) |
| | |
| Net change in cash and cash equivalents | \$ (3,61) |
| Cash and cash equivalents at beginning of period | 9,67 |
| Cash and cash equivalents at end of period | \$ 6,05 |

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

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INCOME (LOSS)

For the six months ended June 30, 2004 and June 30, 2005

(In thousands)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Comprehensive Income (loss) | Accumu Oth Compre Income |
|---|-----------------|----------------------------------|----------------------|--------------------------------|-----------------------------------|
| Balance December 31, 2003 (audited) | \$ 245 | \$ 6,918 | \$ 12,314 | \$ -- | \$ (|
| Comprehensive income: | | | | | |
| Net income | -- | -- | 1,383 | \$1,383 | |
| Other comprehensive income: | | | | | |
| Unrealized gain on securities, net of taxes of \$155 | -- | -- | -- | 71 | |
| Comprehensive income: | -- | -- | -- | \$1,454 | |
| Treasury stock purchase | -- | -- | -- | | |
| Stock options exercised | 13 | 680 | -- | | |
| Cancelled treasury stock | (4) | (406) | -- | | |
| Forgiveness of Uncommon Care Debt | -- | -- | 60 | | |
| Balance June 30, 2004 (unaudited) | \$ 254 | \$ 7,192 | \$ 13,756 | \$ -- | \$ (|
| Balance December 31, 2004 (audited) | \$ 265 | \$ 7,919 | \$ 13,948 | \$ -- | \$ 2 |
| Comprehensive income: | | | | | |
| Net income | -- | -- | 2,220 | \$ 2,220 | |
| Other comprehensive income: | | | | | |
| Unrealized loss on securities, net of taxes of \$229 | -- | -- | -- | (445) | |
| Comprehensive income: | -- | -- | -- | \$ 1,775 | |
| Stock options exercised | 11 | 557 | -- | | |
| Tax benefit from exercise of stock options | -- | 166 | -- | | |
| Treasury stock purchase | -- | -- | -- | | |
| Cancelled treasury stock | (9) | (1,105) | -- | | |
| Stock awarded | 1 | 158 | -- | | |
| Balance June 30, 2005 (unaudited) | \$ 268 | \$ 7,695 | \$16,168 | \$ -- | \$ |

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2005
(Unaudited)

1. GENERAL

The accompanying unaudited condensed 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 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 six months ended June 30, 2005 and 2004 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, 2004 filed with the Securities Exchange Commission should be read in conjunction with this Quarterly Report on Form 10-Q. 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 2005 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

The Internal Revenue Service ("the IRS") has examined our federal income tax return for the year ended December 31, 2003. On April 13, 2005 we received notification that the IRS disagreed with the timing of bad debt expenses deducted for tax purposes in 2003 related to worthless loans receivable. As discussed in our Form 10-Q for the period ended March 31, 2005,

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we disputed the IRS' position and made no provision in the first quarter of 2005 for interest on the perceived underpayment in the 2003 year, which would have been approximately \$82,000. On July 13, 2005 we received notification from the IRS informing us that they will allow our 2003 bad debt deduction and that no penalty or interest will be charged.

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

4. GAIN ON SALE OF ASSETS

During the six months ended June 30, 2005, we recognized \$244,000 of deferred gain related to the November 2001 sale and subsequent leaseback of real estate to Prime Medical (now called HealthTronics, Inc.). Due to our continuing involvement in the property, we deferred recognizing approximately \$2,400,000 of the approximately \$5,100,000 gain and are recognizing it in earnings, as a reduction of rent expense, monthly through November 2006. A total of \$691,000 remains to be recognized in the coming seventeen months. In addition, 15% of the gain (\$760,000) related to our then 15% ownership in the purchaser, was deferred. As our ownership percentage in HealthTronics declines through our sales of HealthTronics common stock, we recognize these gains proportionately to our reduction of our interest in HealthTronics. During the first six months of 2005 we recognized \$84,000 of these deferred gains, leaving a balance of approximately \$96,000 remaining to be recognized.

5. GAIN ON SALE OF INVESTMENTS

The gains resulted primarily from the sales of available-for-sale equity and fixed income securities. During the three and six month periods ended June 30, 2005, we received net cash proceeds of approximately \$3,021,000 and \$4,175,000, respectively, and recognized gains of \$1,346,000 and \$1,977,000, respectively, resulting from these sales.

6. LOSS ON IMPAIRMENT OF INVESTMENT

On June 4, 2003 we purchased from Financial Industries Corporation ("FIC") (OTC: FNIN.PK) and a foundation 339,879 shares of FIC's common stock as an investment. Earlier in 2003 we had purchased 45,121 FIC shares in the open market. The 385,000 shares represent an approximate 4% ownership in FIC. The aggregate purchase price was approximately \$5,647,000, which was all sourced from our cash reserves. The shares purchased from FIC and the foundation are not registered, but are subject to a registration rights agreement requiring FIC's best efforts to register them within one year of the transaction. Due to FIC's delay in filing its 2003 Form 10-K and its subsequent 10-Q's and 10-K, it has not been able to register these shares and was delisted from the NASDAQ exchange in July, 2004.

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During 2004, the value of our investment in FIC had declined significantly. On October 12, 2004, we determined that this decline in market price should be considered "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. Consequently, we recorded pretax charges to earnings totaling \$2,567,000 during the third and fourth quarters of 2004. These charges reduced our cost basis in FIC from \$5,647,000, or \$14.67 per share, to \$3,080,000, or \$8.00 per share which was equal to the quoted market price of FIC shares on December 31, 2004. As discussed in our Form 10-K dated December 31, 2004, we believe the decline in the market price of FIC has been brought about by its failure to file its 2003 Form 10-K and its

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subsequent de-listing from the NASDAQ Stock Market. We had expected FIC to bring its filings current and pursue restoring its exchange listing by March 31, 2005. These events have not yet occurred. As a result, we chose to take an additional pretax charge to earnings during the first quarter of 2005 of \$39,000, further reducing our cost basis in FIC to \$3,042,000, or \$7.90 per share which was equal to the quoted market price of FIC shares on March 31, 2005. While we currently continue to have the ability and the intent to hold the stock indefinitely, we concluded that the additional uncertainty created by the late filings together with the lack of current financial information dictated that the decline should be viewed as other than temporary. No additional charge to earnings resulting from the FIC investment was taken during 2nd quarter of 2005 as FIC's price per share had risen to \$8.00 at June 30, 2005. This second quarter market value increase resulted in an increase to our investment in available-for-sale equity securities of \$38,500, an increase in accumulated other comprehensive income of \$25,400 and an increase in non-current deferred tax liability of \$13,100.

In April 2004 we purchased \$300,000 of Toys R Us bonds. In March, 2005 Toys R Us announced a plan of merger with another toy company and a planned leveraged buyout which precipitated a drop in the price of the bonds. An independent analysis indicated that the new debt to be issued will put the existing bonds in a subordinated position. Since these bonds have a 2018 maturity, we believe that the impairment is "other than temporary" during our shorter expected holding period. Consequently, we wrote a charge against earnings of \$57,000 using the quoted price of the bonds as of June 30, 2005. We will continue to monitor and evaluate the situation at Toys R Us and further determine if changes in fair market value of the investment are temporary or "other than temporary".

7. GAIN ON FORGIVENESS OF DEBT

We recorded \$12,000 and \$75,000 during the three and six months ended June 30, 2004, respectively, as gain on forgiveness of debt. None was recorded in either period during 2005. The 2004 gain represents that amount of liability that was released in the respective period by participants in our loan to an affiliate, net of \$15,000 interest due them from prior period payments made by Uncommon Care. Due to poor operating results, Uncommon Care was in default and not making scheduled payments under its loan agreement with us in which the participations had been sold. As a result, the loan participants released us from any obligations under the participation agreements. No further releases of the remaining \$24,000 were obtained during 2005.

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8. INVESTMENT IN AVAILABLE-FOR-SALE EQUITY SECURITIES

A significant portion of this balance sheet account is comprised of our investment in FIC common stock. As mentioned in Footnote 6 above, during the first quarter of 2005, we recognized another "other than temporary" impairment loss and, accordingly, our cost basis in the 385,000 shares of FIC common stock we own was reduced from \$8.00 per share to \$7.90 per share. The effect of the first quarter of 2005 "other than temporary" impairment loss of \$39,000 was to reclassify from accumulated other comprehensive income the unrealized losses to realized losses in the statement of operations. The price has subsequently risen back to \$8.00 per share at June 30, 2005 but no recovery income was recorded in earnings during the second quarter of 2005 and our basis remains at \$7.90 per share. As mentioned earlier, this second quarter market value increase resulted in a net-of-tax increase to accumulated other comprehensive income of \$25,400.

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We classify all of these shares as securities available-for-sale and record temporary unrealized changes in their value, net of tax, in our balance sheet as part of Accumulated Other Comprehensive Income (Loss) in Stockholders' Equity.

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

9. INVESTMENT IN AVAILABLE-FOR-SALE FIXED INCOME SECURITIES

We have invested primarily in U.S. government-backed securities with maturities varying from one to three years, as well as three corporate bonds with Standard and Poor's ratings of no lower than B (investment grade).

10. ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consists of the following:

| | June 30 2005 | December 31 2004 |
|---------------------------|-----------------|---------------------|
| | ----- | ----- |
| Commissions payable | \$ 750,000 | \$ 1,260,000 |
| Taxes payable | 97,000 | 205,000 |
| Vacation | 153,000 | 153,000 |
| 401(k) plan matching | 128,000 | 169,000 |
| Other accrued liabilities | 51,000 | 55,000 |
| | ----- | ----- |
| | \$1,179,000 | \$ 1,842,000 |
| | ===== | ===== |

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11. NET INCOME PER SHARE

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

| | For the Three Months Ended June 30, 2005 | | |
|-------------------------------|--|---------------|-----------|
| | Income | Shares | Per Share |
| | (Numerator) | (Denominator) | Amount |
| | ----- | ----- | ----- |
| Basic EPS | | | |
| Net income | \$1,367,000 | 2,656,000 | \$ 0.51 |
| | | | ===== |
| Diluted EPS | | | |
| Effect of dilutive securities | -- | 220,000 | |
| | ----- | ----- | |

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| | | | |
|------------|----------------------|--------------------|------------------|
| Net income | \$1,367,000 ===== | 2,876,000 ===== | \$ 0.48 ===== |
|------------|----------------------|--------------------|------------------|

For the Three Months Ended June 30, 2004

| | Income (Numerator) ----- | Shares (Denominator) ----- | Per Share Amount ----- |
|-------------------------------|--------------------------------|----------------------------------|------------------------------|
| Basic EPS | | | |
| Net income | \$ 689,000 | 2,505,000 | \$ 0.28 ===== |
| Diluted EPS | | | |
| Effect of dilutive securities | -- | 286,000 | |
| Net income | \$ 689,000 ===== | 2,791,000 ===== | \$ 0.25 ===== |

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For the Six Months Ended June 30, 2005

| | Income (Numerator) ----- | Shares (Denominator) ----- | Per Share Amount ----- |
|-------------------------------|--------------------------------|----------------------------------|------------------------------|
| Basic EPS | | | |
| Net income | \$2,220,000 | 2,649,000 | \$ 0.84 ===== |
| Diluted EPS | | | |
| Effect of dilutive securities | -- | 243,000 | |
| Net income | \$2,220,000 ===== | 2,892,000 ===== | \$ 0.77 ===== |

For the Six Months Ended June 30, 2004

| | Income (Numerator) ----- | Shares (Denominator) ----- | Per Share Amount ----- |
|-------------------------------|--------------------------------|----------------------------------|------------------------------|
| Basic EPS | | | |
| Net income | \$1,383,000 | 2,489,000 | \$ 0.56 ===== |
| Diluted EPS | | | |
| Effect of dilutive securities | -- | 313,000 | |

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| | | | |
|------------|-------------|-----------|---------|
| | ----- | ----- | |
| Net income | \$1,383,000 | 2,802,000 | \$ 0.49 |
| | ===== | ===== | ===== |

12. 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, 2005 and 2004 are shown as follows:

| | Three months ended June 30, | |
|------------------------|-----------------------------|--------------|
| | 2005 | 2004 |
| | ----- | ----- |
| Operating Revenue: | | |
| Financial services | \$ 3,698,000 | \$ 4,227,000 |
| Insurance services | 3,335,000 | 3,068,000 |
| | ----- | ----- |
| Total Segment Revenues | \$ 7,033,000 | \$ 7,295,000 |
| | ===== | ===== |

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| | Three months ended June 30, | |
|--|-----------------------------|------------|
| | 2005 | 2004 |
| | ----- | ----- |
| Operating Income | | |
| Financial services | \$ 428,000 | \$ 567,000 |
| Insurance services | 913,000 | 688,000 |
| Corporate | (673,000) | (511,000) |
| | ----- | ----- |
| Total segments operating income | 668,000 | 744,000 |
| Gain on sale of investments | 1,346,000 | 218,000 |
| Loss on impairment of investment | (57,000) | -- |
| Gain on extinguishment of debt | -- | 12,000 |
| | ----- | ----- |
| Income from operations before interest income taxes and minority interest | 1,957,000 | 974,000 |
| Interest income | 125,000 | 72,000 |
| Other gain | 29,000 | 26,000 |
| Interest expense | -- | 2,000 |
| Income tax expense | 742,000 | 381,000 |
| Minority interest | 2,000 | -- |
| | ----- | ----- |
| Net income | \$ 1,367,000 | \$ 689,000 |
| | ===== | ===== |

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| | Six months ended June 30, | |
|--|---------------------------|---------------|
| | 2005 | 2004 |
| | ----- | ----- |
| Operating Revenue: | | |
| Financial services | \$ 6,965,000 | \$ 8,059,000 |
| Insurance services | 6,730,000 | 6,526,000 |
| Corporate | -- | 1,600,000 |
| | ----- | ----- |
| Total Segment Revenues | \$ 13,695,000 | \$ 16,185,000 |
| | ===== | ===== |
| Reconciliation to Consolidated Statement of Operations: | | |
| Total segment revenues | \$ 13,695,000 | \$ 16,185,000 |
| Less: Intercompany dividends | -- | (1,600,000) |
| | ----- | ----- |
| Total Revenues | \$ 13,695,000 | \$ 14,585,000 |
| | ===== | ===== |

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| | Six months ended June 30, | |
|--|---------------------------|--------------|
| | 2005 | 2004 |
| | ----- | ----- |
| Operating Income | | |
| Financial services | \$ 745,000 | \$ 1,158,000 |
| Insurance services | 1,805,000 | 1,524,000 |
| Corporate | (1,305,000) | (1,012,000) |
| | ----- | ----- |
| Total segments operating income | 1,245,000 | 1,670,000 |
| Gain on sale of investments | 1,976,000 | 245,000 |
| Loss on impairment of investment | (96,000) | -- |
| Gain on extinguishment of debt | -- | 75,000 |
| | ----- | ----- |
| Income from operations before interest income taxes and minority interest | 3,125,000 | 1,990,000 |
| Interest income | 247,000 | 155,000 |
| Other gain | 84,000 | 18,000 |
| Interest expense | 4,000 | 2,000 |
| Income tax expense | 1,219,000 | 78,000 |
| Minority interest | 13,000 | -- |
| | ----- | ----- |
| Net income | \$ 2,220,000 | \$ 1,383,000 |
| | ===== | ===== |

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13. 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 APB 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 option's vesting periods.

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| | Three Months Ended June 30, 2005 | June 30, 2004 |
|---|-------------------------------------|------------------|
| | ----- | ----- |
| Net income as reported | \$ 1,367,000 | \$ 689,000 |
| Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (82,000) | (87,000) |
| | ----- | ----- |
| Pro forma net income | \$ 1,285,000 | \$ 602,000 |
| | ===== | ===== |
| Net income per share | | |
| Basic - as reported | \$ 0.51 | \$ 0.28 |
| | ===== | ===== |
| Basic - pro forma | \$ 0.48 | \$ 0.24 |
| | ===== | ===== |
| Diluted - as reported | \$ 0.48 | \$ 0.25 |
| | ===== | ===== |
| Diluted - pro forma | \$ 0.45 | \$ 0.22 |
| | ===== | ===== |
| | | |
| | Six Months Ended June 30, 2005 | June 30, 2004 |
| | ----- | ----- |
| Net income as reported | \$ 2,220,000 | \$ 1,383,000 |
| Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (134,000) | (173,000) |

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| | | |
|-----------------------------|--------------|--------------|
| | ----- | ----- |
| Pro forma net income | \$ 2,086,000 | \$ 1,210,000 |
| | ===== | ===== |
| Net income per share | | |
| Basic - as reported | \$ 0.84 | \$ 0.56 |
| | ===== | ===== |
| Basic - pro forma | \$ 0.79 | \$ 0.49 |
| | ===== | ===== |
| Diluted - as reported | \$ 0.77 | \$ 0.49 |
| | ===== | ===== |
| Diluted - pro forma | \$ 0.72 | \$ 0.43 |
| | ===== | ===== |

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14. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS 153, Exchanges of Nonmonetary Assets, an amendment of APB No. 29, Accounting for Nonmonetary Transactions. SFAS 153 requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), "Share-Based Payment". Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments used. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after December 31, 2005. We are currently evaluating the effect of adoption of SFAS 123(R) will have on our overall results of operations and financial position

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Forward-Looking Statements

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

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

GENERAL

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

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

- o APS FINANCIAL. APS Financial is a fully licensed broker/dealer that provides brokerage and investment services primarily to institutional and high net worth individual clients. APS Financial also provides portfolio accounting, analysis, and other services to insurance companies, banks and public funds. We recognize commissions revenue, and the related compensation expense, on a trade date basis.
- o ASSET MANAGEMENT. Asset Management manages fixed income and equity assets for institutional and individual clients on a fee basis. We recognize fee revenues monthly based on the amount of funds under management.

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

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

In addition, as of June 30, 2005, we have the following significant investments accounted for as available-for-sale securities: (1) we own approximately 296,000 shares of HealthTronics (formerly Prime Medical) common stock, representing about 1% of its outstanding common stock, and (2) we own 385,000 shares of Financial Industries Corporation, representing approximately 4% of its outstanding common stock. We account for these investments as available-for-sale securities, which means they are reflected on our consolidated balance sheets at fair value, and fluctuations in fair value are recognized as unrealized gains or losses excluded from earnings and reported as a separate component of stockholders' equity, net of income taxes.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

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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 service revenues related to management fees are recognized monthly at 13.5% of the earned premiums of the managed company. We also share equally any profits of the managed company, to a maximum of 3% of the earned insurance premiums. Any past losses of the managed company are carried forward and applied against earnings before any profits are shared. The profit sharing component is recorded in the fourth quarter based on the audited financial results of the managed company.

On June 4, 2003 we purchased from Financial Industries Corporation ("FIC") (OTC: FNIN.PK) and a foundation 339,879 shares of FIC's common stock as an investment. Earlier in 2003 we had purchased 45,121 FIC shares in the open market. The 385,000 shares represent an approximate 4% ownership in FIC. The aggregate purchase price was approximately \$5,647,000, which was all sourced from our cash reserves. The

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shares purchased from FIC and the foundation are not registered, but are subject to a registration rights agreement requiring FIC's best efforts to register them within one year of the transaction. Due to FIC's delay in filing its 2003 Form 10-K and its subsequent 10-Q's and 10-K, it has not been able to register these shares and was de-listed from the NASDAQ exchange in July, 2004.

During 2004, the value of our investment in FIC had declined significantly. On October 12, 2004, we determined that this decline in market price should be considered "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. Consequently, we recorded a pretax charge to earnings of \$2,567,000 in 2004. The charge reduced our cost basis in FIC from \$5,647,000, or \$14.67 per share, to \$3,080,000, or \$8.00 per share which was equal to the quoted market price of FIC shares on December 31, 2004. As discussed in our Form 10-K dated December 31, 2004, we believe the decline in the market price of FIC had been brought about by its failure to file its 2003 Form 10-K and its subsequent de-listing from the NASDAQ Stock Market. We had expected FIC to bring its filings current and pursue restoring its exchange listing during 2004. These events have not yet occurred. As a result, we recorded an additional pretax charge to earnings of \$39,000 in the first quarter of 2005. The charge reduced our cost basis in FIC from \$3,080,000, or \$8.00 per share, to \$3,041,000, or \$7.90 per share which was equal to the quoted market price of FIC shares on March 31, 2005. While we currently continue to have the ability and the intent to hold the stock indefinitely, we concluded that the additional uncertainty created by the late filings together with the lack of current financial information dictated that the decline should be viewed as other than temporary. We will continue to closely monitor FIC's situation. No additional charge was necessary in the second quarter of 2005 as the quoted market price of FIC shares had risen to \$8.00 on June 30, 2005.

RESULTS OF OPERATIONS

REVENUES

Revenues from operations decreased \$262,000 (4%) and \$890,000 (6%) in

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the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. Our income from operations before interest, income taxes and minority interest increased \$983,000 (101%) and \$1,135,000 (57%) in the current year three and six months, respectively, compared to the same periods in 2004. Our net income increased \$678,000 (98%) and \$837,000 (61%) in the current year three and six months, respectively, compared to the same periods in 2004. Lastly, our diluted net income per share increased \$0.23 (92%) and \$0.28 (57%) in the current year three and six months, respectively, compared to the same periods in 2004. The reasons for these changes are described below.

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FINANCIAL SERVICES

Our financial services revenue decreased \$529,000 (13%) and \$1,094,000 (14%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. Lower commission revenues were earned at APS Financial, the broker/dealer, which derives most of its revenue from transactions in the fixed income market, in both investment and non-investment grade securities. During the second quarter of 2005 our revenue in the investment grade sector was the hardest hit as the investment climate for bonds continued to be soft. The Federal Reserve has raised rates four times since the beginning of the year, a total of 100 basis points. This continues the trend started in June 2004, since which the Fed has raised rates nine times for a total of 225 basis points. The resulting increase in bond yields causes a decrease in bond prices and a subsequent decline in trading volume. Inflationary pressures continued to be aggravated by rising oil prices which set a new record high in June, rising to over \$60 per barrel. Although our performance in the high yield markets was relatively better than the investment grade market, that market began a sharp correction in the first quarter of 2005 which continued into the second led predominately by the automotive sector. Many of our customers have chosen to stay relatively liquid, reducing their commitment of funds in the fixed income securities where we earn the majority of our commissions.

Our financial services expenses decreased \$390,000 (11%) and \$681,000 (10%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. The primary reason for the current year decrease is a \$264,000 (11%) and \$595,000 (13%) decrease in commission expense in the current year three and six month periods, respectively, compared to the same periods in 2004 resulting from the decrease in commission income mentioned above. In addition, incentive compensation costs were down \$275,000 (69%) and \$421,000 (77%) in the three and six months of 2005, respectively, compared to same periods in 2004, primarily as a result of lower profits at APS Financial for 2005 as well as higher minimum performance thresholds placed upon management in 2005. Partially offsetting these decreases was an increase in payroll expense of \$100,000 (32%) and \$212,000 (35%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. Payroll was up as a result of normal annual merit raises as well as the hiring of two new full-time positions. Also, professional fees increased \$45,000 (108%) and \$112,000 (130%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004 as a result of fees incurred related to Sarbanes Oxley compliance.

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INSURANCE SERVICES

Our insurance services revenues from our premium-based insurance management segment, APS Insurance Services, increased \$267,000 (9%) and \$204,000 (3%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. Management fee revenues rose \$240,000 (11%) and \$529,000 (13%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004 as a result of an increase in earned premium brought about by new business growth in the latter half of 2004. Earned premium was \$34.1 million at June 30, 2005 compared to \$30.2 million at June 30, 2004. Going forward, written premiums, which earn out pro-ratably over an annual basis, have decreased by approximately \$3.0 million this year compared to 2004. The result so far this year has been a decrease of \$20,500 (2%) and \$294,000 (13%) in pass-through commissions earned by third-party agents in the three and six month periods, respectively, compared to the same periods in 2004. As noted in the following paragraph, commissions paid to third party independent agents decreased by an equivalent amount, resulting in no impact on net income. Looking forward, we should expect the rate of growth in management fee revenues in the second half of the year to slow compared to the first half. Risk management fee income has increased \$36,000 (181%) but has decreased \$34,000 (20%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. The three month increase is due to new business written during the quarter. The six month decrease is due to one of our large group's risk rating being upgraded this year which resulted in their not having to pay risk management fees in 2005.

Insurance services expenses increased \$42,000 (2%) but decreased \$77,000 (2%) in the three months ended June 30, 2005 compared to the same period in 2004. The current quarter increase is primarily due to an increase in payroll of \$29,000 (4%) and employee benefits \$20,000 (21%) in 2005 compared to the same three months in 2004. Payroll related costs were up due to normal annual merit raises and increased health insurance costs. In addition, professional fees increased \$22,000 (78%) and \$82,000 (179%) in the current year three and six months, respectively, as a result of fees incurred related to Sarbanes Oxley compliance. Partially offsetting these increases was a decrease in commissions expense of \$21,000 (2%) and \$294,000 (13%), respectively, in the three and six month periods ended June 30, 2005 compared to the same periods in 2004 due to the above-mentioned decrease in commissions paid to third party independent agents.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased \$167,000 (30%) and \$321,000 (30%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. Salaries expense increased \$98,000 (62%) and \$113,000 (36%)

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in the current year three and six month periods, respectively, compared to the same periods in 2004 resulting from a severance payment to a former employee who has since been retained as a tax consultant. In addition, incentive compensation expense increased \$91,000 (58%) and \$137,000 (45%) in the current year three and six month periods, respectively, compared to the same periods in 2004 resulting from additional bonuses that will be paid on the gains from the sale of HealthTronics common stock completed in 2005. Lastly, outside professional fees increased \$77,000 (77%) during the current year six months as a result of fees incurred related to Sarbanes Oxley compliance.

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GAIN ON SALE OF ASSETS

During the six months ended June 30, 2005, we recognized \$244,000 of deferred gain related to the November 2001 sale and subsequent leaseback of real estate to Prime Medical (now called HealthTronics, Inc.) Due to our continuing involvement in the property, we deferred recognizing approximately \$2,400,000 of the approximately \$5,100,000 gain and are recognizing it in earnings, as a reduction of rent expense, monthly through November 2006. A total of \$691,000 remains to be recognized in the coming seventeen months. In addition, 15% of the gain (\$760,000) related to our then 15% ownership in the purchaser, was deferred. As our ownership percentage in HealthTronics declines through our sales of HealthTronics common stock, we recognize these gains proportionately to our reduction of our interest in that company. During the first six months of 2005 we recognized \$84,000 of these deferred gains, leaving a balance of approximately \$96,000 remaining to be recognized. The increase in both periods of the current year is the result of an increased number of HealthTronics shares of common stock sold during 2005.

GAIN ON SALE OF INVESTMENTS

The increase in the current three and six month periods of 2005 is due to the sale of a greater number of available-for-sale equity and fixed income securities in 2005 than were sold in the comparable periods of 2004.

LOSS ON IMPAIRMENT OF INVESTMENT

The loss in the second quarter of 2005 represents a write-down of our investment in Toys R Us bonds. In April 2004 we purchased \$300,000 of Toys R Us bonds. In March, 2005 Toys R Us announced a plan of merger with another toy company and a

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planned leveraged buyout which precipitated a drop in the price of the bonds. An independent analysis indicated that the new debt to be issued will put the existing bonds in a subordinated position. Since these bonds have a 2018 maturity, we believe that the impairment is "other than temporary" during our shorter expected holding period. Consequently, we wrote a charge against earnings of \$57,000 using the quoted price of the bonds as of June 30, 2005. We will continue to monitor and evaluate the situation at Toys R Us and further determine if changes in fair market value of the investment are temporary or "other than temporary".

The loss in the six months ended June 30, 2005 also included a write-down of our investment in Financial Industries ("FIC") common stock that was made in the first quarter. During that quarter, we determined that the decline in market value of FIC common stock should be considered "other than temporary" and we recorded a pretax charge to earnings of \$39,000. This charge reduced our cost basis in FIC from \$3,080,000, or \$8.00 per share, to \$3,041,000, or \$7.90 per share which was equal to the quoted market price of FIC shares on March 31, 2005. We believe the decline in the market price of FIC has been brought about by its failure to file its 2003 Form 10-K and its subsequent de-listing from the NASDAQ Stock Market. We had expected FIC to bring its filings current and pursue restoring its exchange listing but these events have not yet occurred. While we currently continue to have the ability and the intent

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to hold the stock indefinitely, we concluded that the additional uncertainty created by the late filings together with the continued lack of current financial information dictated that the decline should be viewed as other than temporary. At June 30, 2005 the price had recovered to \$8.00 per share but no recovery income was recorded as none is permitted unless the investment is actually sold. As mentioned in our 2004 annual report on Form 10-K, we will continue to monitor and evaluate the situation at FIC and further determine if changes in fair market value of the investment are temporary or "other than temporary".

GAIN ON FORGIVENESS OF DEBT

During the three and six months ended June 30, 2004, we recorded \$12,000 and \$75,000, respectively, as gains on forgiveness of debt. This represented that amount of liability that were released by participants in our loan to this affiliate. Due to poor operating results, Uncommon Care was in default and not making scheduled payments under its loan agreement with us in which the participations had been sold. As a result, the loan participants released us from any obligations under the participation agreements. For the three and six months ended June 30, 2005, no further releases of liabilities have been acquired, therefore no gains were recorded. No further releases of the remaining \$24,000 were obtained during 2005.

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INTEREST INCOME

Our interest income increased \$53,000 (74%) and \$92,000 (59%) in the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. The current year three and six month increases were due to interest earned on a much higher balance of interest-bearing fixed income securities. At June 30, 2005 there was a balance of \$9.1 million compared to a balance of \$2.7 million held at June 30, 2004.

OTHER INCOME (LOSS)

Our other income increased \$3,000 (12%) and \$66,000 (367%) for the three and six month periods ended June 30, 2005, respectively, compared to the same periods in 2004. The increase in the current year six month period represents primarily inventory gains of \$18,000 on securities held at APS Financial during 2005 compared to inventory losses of \$28,000 in 2004.

LIQUIDITY AND CAPITAL RESOURCES

WORKING CAPITAL

Our net working capital was \$12,386,000 and \$10,673,000 at June 30, 2005 and December 31, 2004, respectively. The increase in the current year was due primarily to cash received upon the sale of long-term available-for-sale equity securities which was used, in part, to purchase short-term available-for-sale fixed income securities. Cash and cash equivalents decreased during this period by \$3,614,000 as there were net cash uses in operating, investing and financing activities. Cash from operating activities decreased primarily as a result of cash paid in March for incentive compensation earned and accrued in 2004. Cash from investing activities decreased as purchases of

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available-for-sale securities exceeded cash received from the sales of other available-for-sale securities. Cash from financing activities decreased due to purchases of treasury stock exceeding cash received from the exercise of employee stock options. For details of the amounts described above, refer to the Condensed Consolidated Statements of Cash Flows on page 7 of this Form 10-Q.

Historically, we have maintained a strong working capital position and, as a result, we have been able to satisfy our operational and capital expenditure requirements with cash generated from our operating and investing activities. These same sources of funds have also allowed us to pursue investment and expansion opportunities consistent

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with our growth plans. Although there can be no assurance our operating activities will provide positive cash flow in 2005, we are optimistic that our working capital requirements will be met for the foreseeable future for the following reasons: (1) our current cash position is very strong, with a balance of approximately \$6.1 million comprising 21 percent of our total assets; (2) our investments in available-for-sale equity and fixed income securities could provide an additional \$13.6 million should the need arise; and (3) we renewed a line of credit in April 2005 that is described below.

LINE OF CREDIT

During April 2005, we renewed a \$3.0 million line of credit that was originally established in November 2003 with PlainsCapital Bank. The loan called for interest payments only to be made on any amount drawn until April 15, 2006, when the entire amount of the note, principal and interest then remaining unpaid, became due and payable. At June 30, 2005, there were no draws taken against this line of credit. We are in compliance with the covenants of the loan agreement, including requirements for a minimum of \$5.0 million of unencumbered liquidity and a minimum 2 to 1 net worth ratio.

CAPITAL EXPENDITURES

Our capital expenditures for equipment were \$171,000 in the six months of 2005. The majority of these expenditures were necessary to upgrade our reporting software at our insurance services subsidiary. At June 30, 2005, our reporting software upgrade is considered to be "in progress" with anticipated implementation in phases during the rest of 2005 and 2006. Those assets purchased during 2005 that have not been placed in service, are appropriately not being depreciated. We expect capital expenditures in 2005 to be approximately \$500,000, including \$200,000 in improvements to our business intelligence reporting software. Our 2005 capital expenditure budget is expected to be funded through cash on hand.

ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS 153, Exchanges of Nonmonetary Assets, an amendment of APB No. 29, Accounting for Nonmonetary Transactions. SFAS 153 requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the

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transactions lack commercial substance. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), "Share-Based Payment". Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments used. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after December 31, 2005. We are currently evaluating the effect of adoption of SFAS 123(R) will have on our overall results of operations and financial position.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Risk

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

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Changes in interest rates could have an impact at our broker/dealer subsidiary, APS Financial. The general level of interest rates may trend higher or lower in 2005, and this move may impact our level of business in different fixed-income sectors. If a generally improving economy is the impetus behind higher rates, then while our investment grade business may drop off, our high yield business might improve with improving credit conditions. A volatile

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interest rate environment in 2005 could also impact our business as this type of market condition can lead to investor uncertainty and their corresponding willingness to commit funds.

As we currently have no debt and do not anticipate the need to take on any debt in 2005, interest rate changes will have no impact on our financial position as it pertains to interest expense.

Investment Risk

As of June 30, 2005, our recorded basis in debt and equity securities was approximately \$16.7 million. We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that such declines in the fair value of such assets below our accounting basis are other-than-temporary. See Footnote 6 to this report on Form 10-Q for a detailed description of charges to earnings in the prior year and the current quarter that were considered to be "other than temporary".

We also have an investment of 296,000 shares of common stock of HealthTronics, Inc. Although we have an unrealized gain of approximately \$2,356,000 as of June 30, 2005, this investment can also be at risk should market or economic conditions change for the worse or should adverse situations occur at HealthTronics, such as a major product line becoming obsolete. The remainder of our corporate equity and fixed income investments share the same risks as HealthTronics but our exposure is much lower.

Item 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure controls and procedures,

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management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. As of the end of the period covered by this report, and under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of these disclosure procedures. Based on this evaluation and subject to the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in reaching a reasonable level of assurance of achieving management's desired controls and procedures objectives.

There have been no changes in internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

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As part of a continuing effort to improve our business processes we are evaluating our internal controls and may update certain controls to accommodate any modifications to our business processes or accounting procedures.

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PART II

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

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Items 2(a) through(d) are inapplicable.

(e) Stock Repurchases

| Period | a) Total Number of shares Purchased (1) | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) |
|----------------------------|---|--|---|-----|
| | ----- | ----- | ----- | |
| Apr 1, 2005 - Apr 30, 2005 | 7,100 | \$ 12.94 | 7,100 | |
| May 1, 2005 - May 28, 2005 | 62,470 | \$ 12.24 | 62,470 | |

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June 1, 2005 - June 31, 2005

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- (1) Of the total shares purchased 14,570 were purchased in open market transactions and 55,000 were purchased in private transactions. Our share repurchase program was announced August 17, 2004 and authorizes the purchase of up to \$2 million of common stock.

Item 3. Defaults Upon senior Securities

Not Applicable

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Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On June 14, 2005 the annual meeting of American Physicians Service Group, Inc. was held in Austin, Texas. Shareholders voted and approved the following motions:

ELECTION OF DIRECTORS

The names of the directors elected at the meeting along with numbers of votes for and withheld are as follows:

| Name | For | Withheld |
|--------------------|-----------|----------|
| ----- | ----- | ----- |
| Lew N. Little, Jr. | 1,995,831 | 242,927 |
| Jackie Majors | 1,996,928 | 241,830 |
| William A. Searles | 1,996,931 | 241,827 |
| Kenneth S. Shifrin | 2,004,331 | 234,427 |
| Cheryl Williams | 2,005,827 | 232,931 |

PROPOSAL 2 - TO APPROVE THE 2005 INCENTIVE AND NON-QUALIFIED STOCK OPTION PLAN

The Plan provides for the granting of options to purchase up to 350,000 shares of our common stock with certain provisions. The votes for, against and abstain are as follows:

| For | Against | Abstain or Non-Vote |
|-----------|---------|---------------------|
| ----- | ----- | ----- |
| 1,150,207 | 421,892 | 666,659 |

Proposal 2 Passed

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PROPOSAL 3 - TO APPROVE THE AMERICAN PHYSICIANS SERVICE GROUP, INC. AFFILIATED
GROUP DEFERRED COMPENSATION PLAN

The Plan provides for the granting of up to 150,000 shares of our common stock to directors and key employees. Shares granted under the Plan are in lieu of cash awards or stock option grants under current incentive plans and do not represent additional incentives. The votes for, against and abstain are as follows:

| For | Against | Abstain or Non-Vote |
|-----------|---------|---------------------|
| ----- | ----- | ----- |
| 1,197,029 | 376,070 | 665,659 |

Proposal 3 Passed

Item 5. OTHER INFORMATION

Not Applicable

Item 6. EXHIBITS

Exhibits

| | |
|------|--|
| 31.1 | Section 302 Certification of Chief Executive Officer |
| 31.2 | Section 302 Certification of Chief Financial Officer |
| 32.1 | Section 906 Certification of Chief Executive Officer |
| 32.2 | Section 906 Certification of Chief Financial Officer |

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