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Linda A. Watters, Commissioner

REPORT OF EXAMINATION

OF

AMERICAN PHYSICIANS ASSURANCE CORPORATION

East Lansing, Michigan

As of

December 31, 2003

Examined by the
Office of Financial and Insurance Services
Lansing, Michigan

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In accordance with Section 222 of the Michigan Insurance Code, the Office of Financial and Insurance Services produced 50 copies of this report at a total cost of $51.00 or $1.02 each. This cost is funded by assessment fees charged to the insurance companies.

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Commissioners:

In accordance with instructions and pursuant to statutory requirements, we have examined the financial condition, management and operations of:

American Physicians Assurance Corporation
1301 N. Hagadorn Road
East Lansing, Michigan

a stock property and casualty insurer, hereinafter referred to as the "Company." Our examination report follows.

SCOPE OF EXAMINATION

The Office of Financial and Insurance Services (OFIS) conducted an examination of the Company for the period from January 1, 2000 to December 31, 2003. We conducted the examination in accordance with guidelines and procedures recommended by the Financial Condition (E) Committee of the National Association of Insurance Commissioners (NAIC) and the laws, rules and regulations prescribed by OFIS. We conducted concurrent examinations of Insurance Corporation of America and APSpecialty Insurance Corporation, the Company's affiliates.

We reviewed and incorporated certain workpapers of the Company's independent auditors, PricewaterhouseCoopers LLP, into our examination workpapers where appropriate.

To determine the adequacy of the Company's reserves and related actuarial items, we hired the actuarial consulting services of Mercer Oliver Wyman Actuarial Consulting, Inc. The analysis, performed by Alan M. Crowe, FCAS, MAAA, consisted of the tests necessary to certify the adequacy of the reserves and related actuarial items. The actuarial certification is shown in the report of examination as Exhibit 1 and the detailed report is on file at our offices. We have tested the underlying data provided to the actuary for completeness and accuracy.

We verified and determined the Company's assets and liabilities as of December 31, 2003. We performed a limited review of the period between the prior examination and this December 31, 2003 examination. This review consisted mainly of an analytical review of the changes in the balance sheet, a review of the minutes of the board of directors and annual meetings of the stockholders, and a review of any items we deemed necessary. We also performed a limited market conduct review.

Our examination included a review of the following matters that have an impact on the Company's financial condition or conformity with related laws:

Conflict of Interest
Fidelity Bond and Other Insurance
Underwriting
Accounts and Records
Treatment of Policyholders
Advertising

In addition, we reviewed transactions occurring subsequent to December 31, 2003 as deemed appropriate. Comment on the findings of our examination is limited to matters involving a departure from laws, rules or regulations; a significant change in the amount of an item; or a necessary explanation. Any other adjustments or comments were discussed with Company personnel and may appear in a letter to management that was prepared in conjunction with this report of examination.

HISTORY AND PURPOSE

The Company was incorporated under the provisions of Act 218 of the Public Acts of 1956, as amended. The Commissioner of Insurance issued the Company's certificate of authority on May 12, 1976, at which time the Company commenced business.

The Company's certificate of authority was amended August 16, 1979, to authorize the Company to transact the business of insurance as provided under Chapter Six, excluding Section 602 of the Michigan Insurance Code.

The Company was formerly known as Mutual Insurance Corporation of America (MICOA). On December 31, 2000, the conversion of MICOA from a mutual company to a stock corporation was consummated according to a plan of conversion adopted by the board of directors of MICOA on June 28, 2000, with subsequent amendment on October 2, 2000. The plan was approved by MICOA policyholders at a special meeting held on November 29, 2000, and subsequently by OFIS. The plan of conversion included several key components including: formation of American Physicians Capital, Inc. to be the ultimate parent holding company; the conversion of the Company from a mutual insurance company to a stock company, wholly-owned by American Physicians Capital, Inc.; and, the transfer of Insurance Corporation of America, RML Insurance Company, APConsulting, LLC, APDirect Sales, LLC, Preferred Ventures, Inc., now defunct and Alpha Advisors, Inc. from MICOA to wholly-owned subsidiaries of American Physicians Capital, Inc.

The term of existence of the Company is in perpetuity.

CAPITAL STOCK

The Company's authorized capital stock consists of 100,000 shares of common stock; each share has a $100 par value. Twenty-five thousand shares are issued and outstanding as of December 31, 2002. Paid in capital consists of common stock and $63,800,502 of contributed surplus.

MANAGEMENT AND CONTROL

Holding Company Structure

The Company is owned by its parent company, American Physicians Capital, Inc. (APCapital). APCapital also owns Insurance Corporation of America (ICA) and APSpecialty Insurance Corporation (APSpecialty), which are affiliated companies.

An organizational chart is shown in the report of examination as Exhibit 2.

Shareholders

Each shareholder shall be entitled to notice of and to vote at each annual or special meeting of the shareholders. For each matter submitted to a vote, the shareholders shall be entitled to one vote for each share of stock held. If a quorum is present the affirmative vote of the majority of the outstanding and issued shares represented at the meeting, in person or by proxy, entitled to vote on the subject matter shall constitute the action of the shareholders.

At any shareholder meeting, the presence in person or by proxy of the holders of a majority of the outstanding and issued shares entitled to vote at the meeting shall constitute a quorum.

Board of Directors

The business and affairs of the Company are managed by or under the direction of a board of directors consisting of not fewer than three nor more than fifteen directors. The exact number of directors is determined from time to time by resolution adopted by affirmative vote of a majority of the board of directors.

The directors shall be elected by the shareholders at each annual meeting, or at a special meeting called for that purpose, following the formal nomination process. The directors are elected by a plurality vote of the shareholders represented at such meeting and are elected for staggered terms of three years with one third of the directors standing for election each year on a rotating basis. Any directors appointed to complete a term vacated or elected to increase the size of the board may be appointed or elected for a term of less than three years if the board, for purposes of facilitating the staggering of terms, so chooses.

A director shall hold office until the annual meeting for the year in which his term expires and until his successor shall be elected and shall qualify. Prior to death, resignation or retirement, a director may be removed only for cause. Any vacancy on the board of directors that results from an increase in the number of directors or for any other reason may be filled by a majority of the board of directors elected and serving.

Directors serving as of December 31, 2003 are as follows:

Name	Affiliation
William B. Cheeseman	Retired President and CEO of APCapital
John W. Hall, M.D.	Urologist
Stephen H. Haynes, M.D.	General Surgeon
William B. Monnig, M.D.	Urologist
Thomas C. Payne, M.D.	Retired Radiologist
Mitchell A. Rinek, M.D.	Dermatologist
Spencer L. Schneider, Esq.	Attorney
Dawn E. Springer, M.D.	Family Practitioner
Thomas E. Stone, M.D.	Urologist

Committees

Executive Committee
Thomas C. Payne, M.D., Chair
Thomas E. Stone, M.D., V. Chair
William B. Cheeseman
Mitchell A. Rinek, M.D.
Dawn E. Springer, M.D.

Nominating Committee
Thomas E. Stone, M.D., Chair
Stephen H. Haynes, M.D.
Mitchell A. Rinek, M.D.

Audit/Operations Committee
Stephen H. Haynes, M.D., Chair
Mitchell A. Rinek, M.D., V. Chair
William B. Monnig, M.D.
Thomas C. Payne, M.D.
Thomas E. Stone, M.D.

Investment/Finance Committee
John W. Hall, M.D., Chair
Dawn E. Springer, M.D., V. Chair
William B. Monnig, M.D.
Mitchell A. Rinek, M.D.
Thomas C. Payne, M.D.

CME Committee
Thomas E. Stone, M.D., Chair
Dawn E. Springer, M.D., V. Chair
John W. Hall, M.D.
Stephen H. Haynes, M.D.
Thomas C. Payne, M.D.
Mitchell A. Rinek, M.D.

Risk Management Committee
Thomas E. Stone, M.D., Chair
Mitchell A. Rinek, M.D., V. Chair
John W. Hall, M.D.
Stephen H. Haynes, M.D.
Thomas C. Payne, M.D.
Dawn E. Springer. M.D.

Officers

Officers of the Company shall be appointed by the board of directors. Officers shall be elected by the directors present at any annual meeting or special meeting called for the purpose of electing an officer or officers.

Officers serving as of December 31, 2003 are as follows:

Name	Title
Richard K. Clinton	President and CEO
Annette E. Flood	Secretary
Frank H. Freund	Treasurer
Thomas C. Payne, M.D.	Chairman
Thomas E. Stone, M.D.	Vice Chairman

TERRITORY AND PLAN OF OPERATION

The Company is primarily engaged in providing medical professional liability, workers' compensation and health insurance. Medical professional liability insurance is primarily provided to health care providers in Florida, Illinois, Kentucky, Michigan, New Mexico and Ohio. Workers' compensation coverage is written throughout the Midwest. All of the Company's health insurance premiums are written in connection with a single preferred provider organization located in West Michigan.

The Company began exiting the Florida market in December 2002. The Company plans to exit the group accident and health market through non-renewals to commence in July 2004. Through a novation involving ICA, the Company has exited the workers' compensation market.

REINSURANCE

Professional Liability

The Company's program of reinsurance for medical professional liability business consists of a Primary Excess of Loss agreement and an Excess Cessions agreement.

The Primary Excess of Loss Reinsurance Contract covers medical practitioners' liability (including dentists' liability), hospital liability, and allied health providers' liability. The contract reinsures all ancillary coverages (including hired and non-owned automobile liability policies and employers' liability coverage), related commercial general liability business and umbrella/excess liability business. Subject policies are limited to $1,000,000.

Coverage A of the Primary Excess of Loss Reinsurance Contract covers losses up to $500,000 in excess of $500,000 for each insured for each claim. Coverage B covers losses up to $4,000,000 in excess of $1,000,000 respecting any one loss event. The following reinsures participate in the contract: American Re-Insurance Company (45 percent), Hannover Ruckversicherungs-Aktiengesellschaft (40 percent) and Transatlantic Reinsurance Company (15 percent). All participating reinsurers are authorized in Michigan.

The following reinsurers partcipate in the Excess Cessions Reinsurance arrangement: Swiss Reinsurance America Corporation (25 percent), Hannover Ruckversicherungs-Aktiengesellschaft (35 percent), Transatlantic Reinsurance Company (15 percent) and Lloyd's Underwriters (25 percent). All participating reinsurers are authorized in Michigan. The contract covers losses for the business described above up to $1,000,000 in excess of $1,000,000 for each insured for each loss, except for that portion of subject business ceded to Swiss Reinsurance America Corporation. Swiss Reinsurance America Corporation does not assume hospital liability, any ancillary coverages and umbrella/excess liability business under this arrangement. However, the Company does not cede these lines of business under the arrangement. Subject policies are those written in excess of $1,000,000.

Workers' Compensation

The Company has four layers of excess of loss coverage for business classified as workers' compensation insurance and employers' liability insurance. Losses up to $4,000,000 in excess of $1,000,000 per occurrence are ceded under the first excess cover. Losses up to $5,000,000 in excess of $5,000,000 per occurrence are ceded under the second excess cover. Losses of $10,000,000 in excess of $10,000,000 per occurrence are ceded under the third excess cover. Losses of $10,000,000 in excess of $20,000,000 per occurrence are ceded under the fourth or catastrophe excess of loss layer. This arrangement also includes coverage for claims arising from terrorism. Losses of $19,000,000 in excess of $1,000,000 per occurrence and in aggregate are covered. Business under this arrangement is ceded to General Reinsurance Corporation, a company authorized in Michigan.

Excess coverage in Minnesota must be purchased from the Minnesota Workers Compensation Reinsurance Association (WCRA). The Company selected retention of $720,000 per claim. The WCRA provides statutory coverage in excess of this retention.

Group Accident and Health

The Company reinsures its group accident and health business through American National Insurance Company, which is authorized in Michigan. Losses of $900,000 excess of $100,000 per person per policy year are ceded under the first layer. Losses of $1,000,000 in excess of $1,000,000 per person per policy year are ceded under the second layer.

Michigan Catastrophic Claims Association

The Company is required to participate in the Michigan Catastrophic Claims Association (MCCA) as are all insurance carriers writing automobile insurance in the state of Michigan. Premiums are paid to the MCCA based on the rate established annually by the governing board. Applicable Michigan personal injury protection (PIP) losses are reimbursed by the MCCA. The Company discontinued writing automobile insurance in 2001.

Assumed Reinsurance

The Company assumes a small amount of claims-made medical professional liability insurance from non-affiliated insurers.

GROWTH OF THE COMPANY

The data below depicts the growth of the Company from December 31, 1999 to December 31, 2003.

Year	Admitted Assets	Liabilities	Capital and Surplus
1999*	$611,258,103	$431,429,202	$179,828,901
2000	$744,539,483	$514,825,351	$229,714,132
2001	$798,048,556	$621,229,197	$176,819,360
2002	$820,633,526	$657,167,770	$163,465,756
2003*	$743,840,993	$630,545,138	$113,295,855

Year	Net Premiums Written	Net Premiums Earned	Premiums Written to Surplus
1999*	$143,791,949	$132,870,872	.80:1
2000	$177,793,205	$173,836,076	.77:1
2001	$197,155,040	$178,223,300	1.11:1
2002	$231,981,485	$228,802,112	1.41:1
2003*	$131,925,799	$146,415,944	1.16:1

Year	Losses Incurred	Loss Ratio	Loss Adjustment Expenses Incurred	Loss Adjustment Expense Ratio
1999*	$ 71,569,726	53.9%	$46,594,933	35.1%
2000	$102,229,692	58.8%	$45,763,387	26.3%
2001	$161,355,645	90.5%	$75,283,562	42.2%
2002	$174,757,631	76.4%	$63,963,957	28.0%
2003*	$120,510,990	82.3%	$56,191,820	38.3%

Year	Underwriting Expenses Incurred	Underwriting Expense Ratio	Combined Loss and Expense Ratio
1999*	$41,670,195	29.0%	118.0%
2000	$44,105,963	24.8%	109.9%
2001	$46,405,905	23.5%	156.2%
2002	$47,962,768	20.7%	125.1%
2003*	$44,413,170	33.6%	154.2%

* Per Report of Examination.

AMERICAN PHYSICIANS ASSURANCE CORPORATION
BALANCE SHEET
As of December 31, 2003

ASSETS	
Bonds	$551,245,667
Preferred Stocks	100,000
Common Stocks	8,659,834
Real Estate Occupied by Company	8,423,504
Real Estate Held for Production of Income	1,438,140
Cash and Short-term Investments	55,424,102
Other Invested Assets	28,331,174
Receivable for Securities	679,931
Investment Income Due and Accrued	9,695,054
Agents' Balances in Course of Collection	5,869,355
Agents' Balances Booked But Deferred and Not Yet Due	47,997,180
Amounts Recoverable from Reinsurers	4,628,527
Funds Held by or Deposited with Reinsured Companies	4,336
Current Federal and Foreign Income Tax Recoverable	424,200
Net Deferred Tax Asset	5,235,469
Electronic Data Processing Equipment and Software	868,448
Receivable from Parent, Subsidiaries and Affiliates	1,937,514
Aggregate Write-ins for Other than Invested Assets	12,878,559
Total Assets	$743,840,993
LIABILITIES, CAPITAL AND SURPLUS	
Losses	$348,343,466
Loss Adjustment Expenses	148,497,589
Commissions Payable, Contingent Commissions and Other Similar Charges	636,929
Other Expenses	5,009,151
Taxes, Licenses and Fees	1,372,032
Unearned Premiums	89,156,884
Advance Premiums	4,181,504
Ceded Reinsurance Premiums Payable	24,982,355
Funds Held by Company Under Reinsurance Treaties	231,000
Amounts Withheld or Retained by Company for Account of Others	340,626
Provision for Reinsurance	82,000
Aggregate Write-ins for Liabilities	$ 7,711,602
Total Liabilities	$630,545,138
Common Capital Stock	2,500,000
Gross Paid in and Contributed Surplus	63,800,502
Unassigned Funds	$ 46,995,353
Total Surplus	$113,295,855
Total Liabilities, Capital and Surplus	$743,840,993

AMERICAN PHYSICIANS ASSURANCE CORPORATION
STATEMENT OF INCOME
For the Year Ending December 31, 2003

INCOME	
Premiums Earned	$146,415,944
DEDUCTIONS	
Losses Incurred	$120,510,990
Loss Expenses Incurred	56,191,820
Other Underwriting Expenses Incurred	44,413,170
Net Underwriting Gain (Loss)	$(74,700,036)
INVESTMENT INCOME	
Net Investment Income Earned	39,200,159
Net Realized Capital Gains	496,437
Net Investment Gain	$ 39,696,596
OTHER INCOME	
Net Loss from Agents' or Premium Balances Charged Off	$ (214,608)
Finance and Service Charges not Included in Premium	378,105
Aggregate Write-ins for Miscellaneous Income (Loss)	(5,882)
Dividends to Policyholders	(402,856)
Federal and Foreign Income Taxes Incurred (Recovered)	(3,049,106)
Net Income (Loss)	$(32,199,575)

AMERICAN PHYSICIANS ASSURANCE CORPATION
STATEMENT OF CAPITAL AND SURPLUS
For the Year Ending December 31, 2003

Capital and Surplus, December 31, 2002	$163,465,756
Net Income (Loss)	(32,199,575)
Net Unrealized Capital Gains (Losses)	(325,499)
Change in Net Deferred Income Tax	7,402,209
Change in Nonadmitted Assets	(20,189,410)
Change in Provision for Reinsurance	142,375
Paid-in Surplus Adjustment	(5,000,000)
Change in Capital and Surplus	$ (50,169,900)
Capital and Surplus, December 31, 2003	$113,295,855

AMERICAN PHYSICIANS ASSURANCE CORPORATION
STATEMENT OF CASH FLOWS
For the Year Ending December 31, 2003

OPERATIONS		
Premiums Collected Net of Reinsurance		$145,782,163
Net Investment Income		43,569,337
Miscellaneous Income		$ 175,472
Total		$189,526,972
Benefits and Loss Related Payments		$142,669,751
Commissions, Expenses Paid, and Aggregate Write-ins for Deductions		97,051,484
Dividends to Policyholders		402,856
Federal and Foreign Taxes Paid		1,141,245
Total		$241,265,336
Net Cash from Operations		$ (51,738,364)
INVESTMENTS		
Proceeds from Investments Sold, Matured, or Repaid:		
	Bonds	$178,391,291
	Stocks	9,699,726
	Net Gains (Losses) on Cash and Short-term Investments	(1,296)
	Miscellaneous Proceeds	4,035,001
	Total Investment Proceeds	$192,124,722
Cost of Investments Acquired		
	Bonds	$179,291,202
	Stocks	18,154,653
	Real Estate	38,140
	Other Invested Assets	1,358,508
	Miscellaneous Applications	4,469,847
	Total Investments Acquired	$203,312,350
Net Cash from Investments		$ 11,187,628)
FINANCING AND MISCELLANEOUS SOURCES		
Cash Provided (Used)		
	Capital and Paid-in Surplus, less Treasury Stock	$ (5,000,000)
	Other Cash Provided (Used)	(938,244)
Net Cash from Financing and Miscellaneous Sources		$ (5,938,244)
Net Increase (Decrease) in Cash and Short-Term Investments		$ (68,864,236)
Cash and Short-Term Investments at December 31, 2002		124,288,338
Cash and Short-Term Investments at December 31, 2003		$ 55,424,102

NOTES TO FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES

The Company prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the State of Michigan Office of Financial and Insurance Services (OFIS). Prescribed statutory accounting practices include a variety of publications of the NAIC, as well as state laws, rules, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

The principal differences between statutory accounting practices and accounting principles generally accepted in the United States of America (GAAP) are: (a) deferred income taxes are calculated in accordance with Statement of Statutory Accounting Principles (SSAP) No. 10 as opposed to in conformity with Statement of Financial Accounting Standards (SFAS) No. 109; (b) certain assets designated as "nonadmitted assets" are excluded from the balance sheet by direct charges to unassigned surplus; (c) acquisition costs relating to acquiring insurance business are charged to income as incurred rather than being deferred and amortized; (d) liabilities for losses and loss adjustment expenses and unearned premiums are presented net of the impact of reinsurance rather than reporting the gross amounts and recording the assets for the amounts related to reinsurance ceded as required by SFAS No. 113; (e) bonds are reported principally at amortized costs rather than reporting certain bonds at fair value as required by SFAS No. 115; (f) the statement of cash flows is presented in accordance with NAIC guidelines as opposed to SFAS No. 95; (g) comprehensive income is not required and, therefore, is not presented in the accompanying financial statements, in accordance with SFAS No. 130; (h) goodwill is evaluated for other than temporary impairment in accordance with SSAP No. 68 rather than the fair value approach required by SFAS No. 142; and (i) equity in earnings of unconsolidated subsidiaries is credited to surplus rather than the accounts being included in consolidated financial statements.

Significant statutory accounting policies include:

Codification Adoption
Effective January 1, 2001, OFIS required that insurance companies domiciled in the State of Michigan prepare their statutory basis financial statements in accordance with the NAIC *Accounting Practices and Procedures Manual—Effective January 1, 2001* subject to any deviations prescribed or permitted by OFIS. The cumulative effect of the change in accounting principles is reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods. As a result of these changes, the Company

reported a change of accounting principle as an adjustment that increased unassigned funds (surplus) by $15,970,710 as of January 1, 2001. Included in this total adjustment is an increase in unassigned funds of $15.1 million related to deferred tax assets.

Investment in Bonds, Stocks, Short –Term Investments and Real Estate
Bonds and stocks are recorded in accordance with rules promulgated by the NAIC. Investment grade bonds (NAIC designation 1 or 2) not backed by other loans are stated primarily at amortized cost using the scientific interest method. Below investment grade bonds (NAIC designation 3 or higher) not backed by other loans are stated at the lesser of fair value or amortized cost with any write-down in the carrying value of the bond being treated as an unrealized loss and charged directly to surplus, net of deferred income tax. Common stocks of non-affiliates are stated at NAIC market value, which approximates fair value. Unrealized gains and losses resulting from differences between the cost and fair value of stocks are credited or charged directly to surplus, net of deferred income tax. Short-term investments are stated at cost, which approximates fair value, and include all investments whose maturities, at the time of acquisition, are one year or less. Real estate is carried at historical cost, less accumulated depreciation. Investments whose decline in market value is considered other than temporary, are recorded at the lesser of cost or fair value with any change in the carrying value of the investment being charged directly to the statement of income as a realized loss. Investment income is recorded when earned. Due and accrued income that is 90 days past due is non-admitted and excluded from surplus. Realized gains or losses on sales of investments are determined on the basis of specific costs of the investments and are credited or charged to income.

Other Invested Assets
Other invested assets are principally investment real estate limited partnerships and are carried at the underlying GAAP equity.

Acquisition Costs
Costs and expenses of acquiring business are charged to expense when incurred, while the related premium income is earned over the periods covered by the policies.

Loss and Loss Adjustment Expenses
Unpaid loss and loss adjustment expenses are estimated actuarially using the Company's past claims experience. These estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes that the reserves for loss and loss adjustment expenses are adequate. The methods for making such estimates and for establishing the resulting liabilities are continually reviewed, and any adjustments are reflected in current earnings. Unpaid losses and loss adjustment expenses are not discounted and are presented net of reinsurance. Losses and loss adjustment expenses are charged to income as incurred.

Premiums
Premiums are earned in accordance with the terms of the related policies and reinsurance agreements. Unearned premiums represent the portion of premiums written that are

applicable to the unexpired terms of policies in force, which are calculated by the application of daily pro-rata fractions.

Premium Deficiency Reserves

Premium deficiency reserves are required for the amount of the anticipated losses, loss adjustment expenses, commissions, and other acquisition costs and maintenance costs that have not previously been expensed in excess of the recorded unearned premium reserve and anticipated investment income on existing policies. The results of this calculation did not indicate a deficiency at December 31, 2003.

Reinsurance

Reinsurance premiums and reserves related to reinsured business are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums ceded to other companies have been reported as a reduction of premium income. Amounts applicable to reinsurance ceded for unearned premiums and loss and loss adjustment expenses have been reported as reductions of these items.

Depreciation

Provisions are made for depreciation of fixed assets using the straight-line method over the following estimated useful lives of the assets: computer software—lesser of useful life or three years; computer hardware—five years; furniture and fixtures—ten years; and buildings—forty years.

Goodwill

Goodwill consists of the excess of cost over fair market value of net assets of acquired businesses. Goodwill is amortized on a straight-line basis over ten years. Approximately $1.4 million was nonadmitted at December 31, 2003 in accordance with the limitation guidance in SSAP No. 68.

Income Taxes

The Company files a consolidated federal income tax return with APCapital and its direct subsidiaries, which is subject to a written tax sharing agreement. Income taxes are allocated based upon separate return calculations giving current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

Non-admitted Assets

Certain assets designated as non-admitted assets have been excluded from the balance sheet and are charged directly to surplus.

Use of Estimates

The preparation of financial statements in conformity with statutory accounting practices requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. INVESTMENTS IN STOCKS AND BONDS

The estimated fair value of bonds is based on published market quotations and other sources and is not materially different from the NAIC market values. The fair value of bonds at December 31, 2003 was $589,916,553. The fair value of stocks as of December 31, 2003 was $9,049,099. Bonds with fair values of $3,076,851 were on deposit with various states as of December 31, 2003. Cash of $675,000 was on deposit with various states at December 31, 2003.

Net gains of $3,183,933 were realized in 2003 on disposal of investments in bonds, while proceeds on disposal of investments in bonds totaled $178,391,291. Also for 2003, net gains of $641,733 were realized on the sales of investments in stocks, while proceeds from the sales of investments in stocks totaled $9,699,726.

3. NON-ADMITTED ASSETS

Non-admitted assets consist of the following at December 31, 2003:

Common Stocks	$ 289,265
Past Due Premium Balances	154,709
Net Deferred Tax Assets	55,431,685
EDP Equipment	4,437,821
Furniture and Equipment	1,217,877
Receivable from Parent, Subsidiaries and Affiliates	6,299
Other Assets Non-admitted	919,528
Aggregate Write-ins for Other than Invested Assets	4,127,469
Total	$66,584,653

4. LOSS AND LOSS ADJUSTMENT EXPENSES

Management believes the estimate for the ultimate liability for loss and loss adjustment expenses at December 31, 2003 is reasonable and reflective of anticipated ultimate experience. However, it is possible that the Company's actual incurred loss and loss adjustment expenses will not conform to the assumptions inherent in the determination of the liability. Accordingly, it is reasonably possible that the ultimate settlement of losses and the related loss adjustment expenses may vary significantly from the estimated amounts included in the accompanying financial statements.

5. REINSURANCE

Ceded reinsurance arises from the Company seeking to reduce its loss exposure on its higher limit policies. The Company has entered into excess of loss contracts mainly for medical professional liability and workers' compensation business.

The Company's policy is to enter into reinsurance contracts only with highly rated insurers. Reinsurance contracts do not relieve the Company from its obligations to policyholders. If the reinsuring company is unable to meet its obligations under existing reinsurance agreements, the Company would be liable for such defaulted amounts. Amounts ceded to reinsurers which have been deducted from the liability for loss and loss adjustment expenses.

While the Company did not commute any reinsurance contracts during 2003, a novation of certain balances was consummated effective August 1, 2003. This novation resulted in select medical malpractice reserves and unearned premiums being novated from the Company's affiliate APSpecialty and certain workers' compensation reserves and unearned premiums being novated to its affiliate ICA. Prior to the novation, the Company participated in an 80/20 quota share reinsurance treaty with its affiliates, APSpecialty and ICA. Balances previously assumed by the Company that were ceded by APSpecialty and ICA were also novated.

The Company had net reinsurance recoverables, including ceded unearned premiums and amounts due to reinsurers, totaling $75,344,000 at December 31, 2003.

6. INCOME TAXES

The Company reported a net admitted deferred tax asset of $5,235,469 at December 31, 2003. The Company non-admitted $55,431,685 of deferred tax assets in accordance with SSAP No. 10. The Company has no unrecognized deferred income tax liabilities.

The Company records the tax effects of temporary differences that give rise to significant portions of its deferred tax assets and liabilities. The change in net deferred income taxes is comprised of changes in gross deferred tax assets less gross deferred tax liabilities, including the tax effect of changes in unrealized losses. The Company's change in net deferred income taxes as of December 31, 2003 was $7,402,209.

The provision for federal income taxes incurred is different from that which would be obtained by applying the statutory federal income tax rate to loss before income taxes. The significant items causing this difference were the change in nonadmitted assets, the reduction in deferred taxes related to novated balances, the establishment of AMT credits and tax exempt interest.

At December 31, 2003, the Company had approximately $5.7 million of net operating loss (NOL) carryforwards related to its merger with New Mexico Physicians Mutual Liability Company in 1997, which are limited in use to approximately $575,000 per year and expire in 2010. It also has approximately $4.1 million in NOL carryforwards related to its 1987 merger with State Mutual Insurance Company, which expire, if unused, in 2012 and are limited to approximately $340,000 annually.

Finally the Company has approximately $8.2 million of minimum tax credits that can be carried forward indefinitely. The Company's 2003 net loss generated a carryforward of approximately $23.7 million, which expires in 2018.

7. RELATED PARTY TRANSACTIONS

At December 31, 2003, the Company reported $1,937,514 due from its parent and affiliates. APCapital, APSpecialty, ICA, and APConsulting, LLC owed the Company $79,817, $79,772, $1,775,359, and $2,566 respectively. Terms of settlement require that these amounts be settled within 30 to 90 days.

8. EMPLOYEE BENEFIT PLANS

The Company sponsored defined contribution and 401(k) plans for employees in 2003. Under the defined contribution plan, the Company contributes 5 percent of participating employees' eligible compensation as defined in a plan document. The Company's contribution for 2003 was $328,712. For the Company-sponsored 401(k) plan, the Company matches 100 percent of the participant's deferred compensation, up to three percent of the participants' eligible compensation, and 50 percent of the participants' deferred compensation that exceeds three percent but does not exceed five percent of the participants' eligible compensation. The Company's 2003 contribution related to the 401(k) plan was $509,886.

9. GOODWILL

The Company purchased a 100 percent interest of Stratton-Cheeseman Management Company (SCMC) effective October 31, 1999. The cost of the acquisition was $19.5 million, resulting in goodwill of $17,831,216. In 2001, the Company wrote off the remaining goodwill related to its acquisition of Kentucky Medical Insurance Company.

10. LEASES

The Company leases office space and equipment under various noncancelable operating lease agreements that have various expiration dates through December 2008. Minimum future lease payments are as follows: 2004--$1,336,000; 2005—$924,000; 2006--$726,000; 2007--$469,000; 2008--$388,000. Rental expense was $1,614,607 in 2003.

11. CONTINGENT LIABILITIES

Various lawsuits against the Company have arisen in the course of the Company's business. Management does not consider contingent liabilities arising from litigation and other matters to be material in relation to the financial position or operations of the Company.

The Company has purchased annuities with life insurance companies under which certain claimants are payees. These annuities have been used to reduce unpaid losses by $4,555,224. The Company has a contingent liability of the same amount should the insurers of these annuities fail to perform under the terms of these annuities.

The Company participates in the guaranty associations of the various states in which premiums are written. Guaranty fund assessments are accrued at the time of the insolvency. Other assessments are accrued either at the time of the assessments, or in the case of premium based assessments, at the time the premiums were written, or in the case of loss based assessments, at the time the losses are incurred.

12. NOTE PAYABLE

The note payable represents the remaining annual installment payments due to William B. Cheeseman, APCapital's former president and CEO, in connection with the purchase of Stratton-Cheeseman Management Company in 1999. The scheduled annual payments would have increased or decreased by $200,000 for each corresponding half-grade increase or decrease in the Company's A.M. Best rating during the term of the payments. Upon Mr. Cheesman's retirement, effective December 31, 2003, the remaining five annual installments totaling $7 million became due. Because of APA's AM Best downgrade in late 2003 each of the remaining annual installments was reduced by $200,000. The total net liability of $6 million carried on the balance sheet at December 31, 2003 was paid on January 2, 2004.

EXAMINATION FINDINGS AND RECOMMENDATIONS

1. Supporting Documentation for Claims

The Company did not have proper documentation supporting individual workers' compensation loss and loss expense payments. Claim forms supporting individual loss and loss expense payments were not retained in the claim files. Additionally, the Company did not have documentation in the workers' compensation claim files supporting individual reserves at year-end.

We recommend the Company retain proper documentation supporting loss and loss expense payments. We also recommend the Company keep documentation in the claim files supporting year-end reserves for each claim.

2. Business Contingency and Disaster Recovery Plans

The Company has not developed a business contingency plan or a disaster recovery plan. It is a good business practice to develop such plans to mitigate the impact of disruptions resulting from disasters. The Company is currently working on a plan which it intends to implement in 2004.

We recommend the Company fully develop, test, and implement a business contingency plan and a disaster recovery plan.

CONCLUSION

As of our December 31, 2003 examination, we determined the Company to have admitted assets of $743,840,993, liabilities of $630,545,138, and capital and surplus of $113,295,855.

We appreciate the cooperation and assistance extended by the officers and employees of the Company.

In addition to the undersigned, Jay L. Mertz, Laura L. Strank, and Elisha M. Pierce, examiners of OFIS; and Mercer Oliver Wyman Actuarial Consulting, Inc., participated in the examination.

Respectfully submitted,

John C. Sands, CFE
Examiner-in-Charge
Office of Financial and Insurance Services