

AMERICAN PHYSICIANS SERVICE GROUP INC  
Form 10-Q  
November 04, 2008

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

---

**FORM 10-Q**

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

For the period ended

September 30, 2008

or

¨ Transition Report Pursuant to Sections 13 or 15(d) of  
the Securities and Exchange Act of 1934

For the transition period from

\_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-31434

**AMERICAN PHYSICIANS SERVICE GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Texas**

**75-1458323**

(State or other jurisdiction of incorporation or organization) (I.R.S. employer identification No.)

**1301 S. Capital of Texas Highway, Suite C-300, Austin, Texas 78746**

(Address of principal executive offices)(Zip Code)

(512) 328-0888

(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

<u>Title of Each Class</u>	<u>Number of Shares Outstanding At</u> <u>October 31, 2008</u>
Common Stock, \$.10 par value	7,042,984

**AMERICAN PHYSICIANS SERVICE GROUP, INC.**

Table of Contents to Quarterly Report on Form 10-Q

For the Quarter Ended September 30, 2008

	<b><u>Page</u></b>
<b>Part I</b>	
<b>Financial Information</b>	
<b>Item 1.</b>	<b><u>Financial Statements</u></b>
	<u>Unaudited Condensed Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007</u> 3
	<u>Unaudited Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2008 and 2007</u> 5
	<u>Unaudited Condensed Consolidated Statement of Shareholders' Equity and Comprehensive Income for the Nine Months Ended September 30, 2008</u> 7
	<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007</u> 8
	<u>Notes to the Unaudited Condensed Consolidated Financial Statements</u> 9
<b>Item 2.</b>	<b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b> 24
<b>Item 3.</b>	<b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b> 45
<b>Item 4.</b>	<b><u>Controls and Procedures</u></b> 47
<b>Part II</b>	
<b>Other Information</b>	
<b>Item 1.</b>	<b><u>Legal Proceedings</u></b> 48
<b>Item 1A.</b>	<b><u>Risk Factors</u></b> 48
<b>Item 2.</b>	<b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b> 48
<b>Item 3.</b>	<b><u>Defaults Upon Senior Securities</u></b> 49
<b>Item 4.</b>	<b><u>Submission of Matters to a Vote of Security Holders</u></b> 49
<b>Item 5.</b>	<b><u>Other Information</u></b> 49
<b>Item 6.</b>	<b><u>Exhibits</u></b> 49



**PART 1****FINANCIAL INFORMATION****AMERICAN PHYSICIANS SERVICE GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(in thousands)	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value	\$ 200,083	\$ 191,609
Equity securities available for sale, at fair value	11,332	11,406
Other invested assets	1,580	1,787
<b>Total investments</b>	<b>212,995</b>	<b>204,802</b>
Cash and cash equivalents	16,491	18,391
Cash - restricted	126	694
Accrued investment income	1,502	1,299
Premium and maintenance fees receivable	18,995	15,946
Reinsurance recoverables on paid and unpaid loss adjustment expenses	16,773	20,019
Other amounts receivable under reinsurance contracts	558	4,535
Deferred policy acquisition costs	2,720	2,514
Subrogation recoverables	217	423
Federal income tax receivable	-	1,957
Deferred tax assets	10,300	7,402
Property and equipment, net	609	350
Intangible assets	1,264	1,045
Other assets	2,267	3,421
<b>Total assets</b>	<b>\$ 284,817</b>	<b>\$ 282,798</b>

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

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

(Unaudited)

(in thousands)	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>Liabilities</b>		
Reserve for loss and loss adjustment expense	\$ 93,447	\$ 101,606
Unearned premiums and maintenance fees	39,807	35,417
Reinsurance premiums payable	39	407
Funds held under reinsurance treaties	4,363	4,651
Trade accounts payable	354	996
Accrued expenses and other liabilities	5,003	7,187
Federal income tax payable	1,043	-
Mandatorily redeemable preferred stock	7,477	8,554
<b>Total liabilities</b>	<b>151,533</b>	<b>158,818</b>
Commitments and contingencies		
<b>Shareholders Equity</b>		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, 8,087 and 9,179 issued and outstanding at September 30, 2008 and December 31, 2007, respectively		
Common stock, \$0.10 par value, 20,000,000 shares authorized, 7,131,056 and 7,213,626 issued and outstanding at September 30, 2008 and December 31, 2007, respectively		
	713	721
Additional paid-in capital	77,622	79,752
Accumulated other comprehensive income (loss), net of taxes	(2,626)	545
Retained earnings	57,575	42,962
<b>Total shareholders equity</b>	<b>133,284</b>	<b>123,980</b>

<b>Total liabilities &amp; shareholders equity</b>	\$	284,817	\$	282,798
--	----	---------	----	---------

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



**AMERICAN PHYSICIANS SERVICE GROUP, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(in thousands)	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>REVENUES</b>				
Gross premiums and maintenance fees written	\$ 21,246	\$ 22,239	\$ 51,106	\$ 37,284
Premiums ceded	711	504	1,087	3,922
Change in unearned premiums & maintenance fees	(6,248)	(5,112)	(4,536)	(3,129)
Net premiums and maintenance fees earned	15,709	17,631	47,657	38,077
Investment income, net of investment expense	2,996	2,904	9,011	5,743
Realized capital loss, net	(474)	(3,195)	(4,312)	(3,659)
Management services	42	70	63	3,765
Financial services	1,558	5,434	4,835	17,623
Other revenue	55	35	87	69
<b>Total revenues</b>	<b>19,886</b>	<b>22,879</b>	<b>57,341</b>	<b>61,618</b>
<b>EXPENSES</b>				
Losses and loss adjustment expenses	2,259	4,624	11,347	7,786
Other underwriting expenses	3,220	3,262	8,322	5,696
Change in deferred policy acquisition costs	(403)	(444)	(206)	(287)
Management services expenses	-	-	-	3,823
Financial services expenses	2,127	4,907	8,013	15,599
General and administrative expenses	1,502	1,608	4,221	3,800

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

Impairment of goodwill	-	-	-	1,247
<b>Total expenses</b>	<b>8,705</b>	<b>13,957</b>	<b>31,697</b>	<b>37,664</b>
Income from operations	11,181	8,922	25,644	23,954
Income tax expense	3,998	3,630	8,935	8,949
Minority interests	-	-	-	1
Net income before extraordinary gain	\$ 7,183	\$ 5,292	\$ 16,709	\$ 15,004
Extraordinary gain, net of taxes	-	-	-	2,264
Net income	\$ 7,183	\$ 5,292	\$ 16,709	\$ 17,268

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

**AMERICAN PHYSICIANS SERVICE GROUP, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(in thousands, except per share data)	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net income per common share				
Basic:				
Net income before extraordinary gain	\$ 1.01	\$ 0.74	\$ 2.33	\$ 3.01
Extraordinary gain	-	-	-	0.46
Net Income	\$ 1.01	\$ 0.74	\$ 2.33	\$ 3.47
Diluted:				
Net income before extraordinary gain	\$ 0.99	\$ 0.73	\$ 2.29	\$ 2.93
Extraordinary gain	-	-	-	0.44
Net Income	\$ 0.99	\$ 0.73	\$ 2.29	\$ 3.37
Basic weighted average shares outstanding	7,134	7,107	7,160	4,977
Diluted weighted average shares outstanding	7,244	7,253	7,286	5,114

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



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

For the Nine Months ended September 30, 2008

(Unaudited)

(In thousands, except share amounts)	Accumulated							Total
	Additional			Other			Total	
	Shares	Common	Paid-In	Retained	Comprehensive	Income	Treasury	Shareholders'
	Outstanding	Stock	Capital	Earnings	Income	(Loss)	Stock	Equity
Balance December 31, 2007	7,213,626	\$ 721	\$ 79,752	\$ 42,962	\$ -	\$ 545	\$ -	\$ 123,980
Comprehensive income:								
Net income	-	-	-	9,526	9,526	-	-	9,526
Other comprehensive income, net of tax:								
Unrealized gain on securities, (net of reclassification adjustment)	-	-	-	-	(1,894)	(1,894)	-	(1,894)
Comprehensive income:					\$ 7,632			
Stock options expensed	-	-	320	-		-	-	320
Stock options exercised- proceeds	9,000	1	83	-		-	-	84

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

Stock options exercised-exchanged	85,500	9	785	-	-	-	794
Tax benefit from exercise of stock options	-	-	360	-	-	-	360
Treasury stock purchases	-	-	-	-	-	(3,592)	(3,592)
Cancelled treasury stock - purchased	(129,019)	(13)	(2,553)	-	-	2,566	-
Cancelled treasury stock - exchanged	(48,381)	(5)	(1,021)	-	-	1,026	-
Common stock awarded	16,500	2	300	-	-	-	302
Dividends paid (\$0.30 per share)	-	-	-	(2,096)	-	-	(2,096)
Balance June 30, 2008	7,147,226	\$ 715	\$ 78,026	\$ 50,392	\$ (1,349)	\$ -	\$ 127,784

Comprehensive income:

Net income	-	-	-	7,183	7,183	-	-	7,183
Other comprehensive income, net of tax:								
Unrealized loss on securities, (net of reclassification adjustment)	-	-	-	-	(1,277)	(1,277)	-	(1,277)
Comprehensive income:					\$ 5,906			
Stock options expensed	-	-	157	-	-	-	-	157
Stock options exercised-exchanged	37,000	3	399	-	-	-	-	402
Tax benefit from exercise of stock options	-	-	125	-	-	-	-	125
Treasury stock purchases	-	-	-	-	-	(1,336)	(1,336)	(1,336)
	(41,417)	(4)	(841)	-	-	845	-	-

Cancelled treasury stock - purchased								
Cancelled treasury stock - exchanged	(23,753)	(2)	(489)	-	-	491	-	
Common stock awarded	12,000	1	245	-	-	-	246	
Balance September 30, 2008	7,131,056	\$ 713	\$ 77,622	\$ 57,575	\$ (2,626)	\$ -	\$ 133,284	

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

**AMERICAN PHYSICIANS SERVICE GROUP, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net Income	\$ 16,709	\$ 17,268
Adjustments to reconcile net income to cash provided by operating activities:		
Amortization and accretion of investments	(253)	(16)
Depreciation and amortization and other	548	218
Realized (gains) losses, net	4,312	3,659
Impairment of goodwill	-	1,247
Change in deferred acquisition costs	(206)	-
Common stock awarded	548	1,379
Stock options expensed	477	1,143
Extraordinary gain	-	(2,264)
Deferred income tax benefit	(706)	(2,976)
Excess tax benefits from stock-based compensation	(485)	(123)
Other non-cash items	(115)	(571)
Changes in operating assets and liabilities, net of business acquisition:		
Restricted cash	568	-
Premium and maintenance fee receivables	(3,049)	(4,487)
Other amounts receivable under reinsurance contracts	3,977	(2,027)
Reinsurance recoverables on unpaid and paid loss expenses	3,246	7,150
Funds held under reinsurance treaties	(288)	(3,741)
Reserve for losses and loss adjustment expenses	(8,159)	(11,370)
Unearned premiums and maintenance fees	4,390	3,161
Other receivables and assets	1,020	5,050
Federal income tax payable	3,000	(2,205)
Accrued expenses & other liabilities	(3,397)	(3,452)
Net cash provided by operating activities	22,137	7,043



**Cash flows used in investing activities:**

Capital expenditures	(728)	(710)
Proceeds from the sale of available-for-sale equity and fixed income securities	40,775	31,863
Purchase of available-for-sale equity securities and fixed income securities	(57,849)	(69,718)
Funds loaned to others	(433)	(275)
Cash received from API acquisition	-	9,910
Collection of notes receivable and other	495	91
Net cash used in investing activities	(17,740)	(28,839)

**Cash flows provided by (used in) financing activities:**

Secondary stock offering and over-allotment	-	35,083
Exercise of stock options	84	182
Excess tax benefits from stock-based compensation	485	123
Repurchases of common stock	(3,411)	(612)
Preferred stock redemption	(1,359)	(1,018)
Dividend paid	(2,096)	(1,416)
Net cash provided by (used in) financing activities	(6,297)	32,342

**Net change in cash and cash equivalents:** (1,900) 10,546

Cash and cash equivalents at beginning of period	18,391	4,242
Cash and cash equivalents at end of period	\$ 16,491	\$ 14,788

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

**AMERICAN PHYSICIANS SERVICE GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2008**

(Unaudited)

**1.**

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ( GAAP ) and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The consolidated unaudited financial statements as of and for the three and the nine month periods ended September 30, 2008 and 2007 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. 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, 2007 filed with the SEC should be read in conjunction with this Quarterly Report on Form 10-Q.

**2.**

**Management's Estimates**

The preparation of financial statements in conformity with GAAP 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.

On an on-going basis, we evaluate our estimates, including our most significant estimates related to: reserve for losses and loss adjustment expenses; death, disability and retirement reserves; reinsurance premiums recoverable/payable;

premiums ceded; deferred policy acquisition costs; impairment of assets including the fair value of investments; 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.

Although considerable judgment is inherent in these estimates, management believes that the current estimates are reasonable in all material respects. The estimates are reviewed regularly and adjusted, as necessary. Adjustments related to changes in estimates are reflected in the Company's results of operations, or other comprehensive income, in the period in which those estimates are changed.

3.

### **New Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard (SFAS) 157, Fair Value Measurements. SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. Under the standard, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts its business. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy.

Effective January 1, 2008, we adopted SFAS 157, *Fair Value Measurements*, for our financial assets and financial liabilities, but have not yet adopted SFAS 157 as it relates to nonfinancial assets and liabilities based on the February 2008 issuance of FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157*, which permits a one-year deferral of the application of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 as it pertains to financial assets and liabilities did not have a material impact on our results of operations, financial position or liquidity. We will adopt FAS 157 for non-financial assets and non-financial liabilities on January 1, 2009 and do not expect the provisions to have a material effect on our results of operations, financial position or liquidity. For additional disclosures, see Note 17, *Fair Value Measurements*.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits entities to choose to measure certain financial assets and liabilities at fair value which are otherwise measured on a different basis in existing literature. Additional disclosures are required. It is effective for the Company, if elected, as of January 1, 2008. We are currently evaluating the impact on our financial position, results of operations or cash flows if we would choose to adopt this standard.

In December 2007, the FASB issued Statement of Financial Accounting Standards, or SFAS, No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt the Statement on its effective date. The adoption is not expected to have a significant effect on our financial position, results of operations or cash flows.

In December 2007, the FASB issued Statement of Financial Accounting Standards, or SFAS No. 141 (Revised December 2007) *Business Combinations* (SFAS 141R). SFAS 141R replaces FASB Statement No. 141, *Business Combinations* but retains the fundamental requirement in SFAS 141 that the acquisition method (referred to as the purchase method in SFAS 141) of accounting be used for all business combinations. SFAS 141R provides new and additional guidance with respect to business combinations including: defining the acquirer in a transaction, the valuation of assets and liabilities when non-controlling interests exist, the treatment of contingent consideration, the treatment of costs incurred to effect the acquisition, the treatment of reorganization costs, and the valuation of assets and liabilities when the purchase price is below the net fair value of assets acquired. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt the Statement on its effective date.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets*. FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the

useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. FSP No. 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We are currently evaluating the impact of the pending adoption of FSP No. 142-3 on our consolidated financial statements.

**4.**

**Acquisition**

On April 1, 2007, we acquired all of the issued and outstanding stock of API. We considered several factors in determining to acquire API, including the favorable effects tort reform had on the Texas market, our long-term experience managing API's operations, our credibility in the marketplace, the common goals we shared with API's board of directors, the ability to increase API's capital to support future growth after the acquisition and the increased financial strength of the combined entities. The results of operations for API are included in our consolidated results of operations beginning April 1, 2007. The business combination was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to assets acquired and liabilities assumed based on fair values at the date of acquisition. The total purchase price was \$45,167,000 and consisted of 1,982,499 shares of the Company's common stock, valued at a per share price of \$17.635, or \$34,961,000 in the aggregate, \$35,000 in cash paid in lieu of fractional shares of common stock, 10,197.95 shares of preferred stock

valued at \$9,179,000, plus costs to complete the acquisition of \$992,000. We are required to redeem at least \$1 million of the preferred stock each calendar year beginning in 2007, until December 31, 2016, at which time all of the preferred stock must have been redeemed. The preferred stock has a cumulative dividend equal to 3% of the outstanding redemption value per year. In June 2008 and June 2007, respectively, we made the first two required redemptions and paid the dividends.

The following table displays the amount of the purchase price assigned to each major asset and liability of API at the acquisition date, April 1, 2007:

(in thousands)

**ASSETS**

**Investments:**

Fixed maturities available for sale	\$ 145,354
Equity securities available for sale	6,851
Other invested assets	1,848
Total investments	154,053
Cash and cash equivalents	9,910
Accrued investment income	793
Premium and maintenance fees receivable	14,647
Other amounts receivable under reinsurance recoverables	1,373
Reinsurance recoverables on paid and unpaid loss adjustment expenses	29,685
Prepaid reinsurance premiums	311
Deferred policy acquisition costs	2,404
Deferred tax assets	4,630
Subrogation recoverables	505
Other assets	358
<b>Total assets</b>	<b>\$ 218,669</b>

**LIABILITIES AND SHAREHOLDERS EQUITY**

**Liabilities**

Reserve for losses and loss adjustment expenses	116,227
Unearned premiums and maintenance fees	36,516
Reinsurance premiums payable	253
Funds held under reinsurance treaties	11,112
Federal income tax payable	2,623
Other liabilities	4,507

<b><i>Total liabilities</i></b>	<b>171,238</b>
Purchase Price	45,167
Excess of net assets received over cost to acquire (1)	2,264
<b><i>Total</i></b>	<b>\$ 218,669</b>

(1)

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

The table below reflects the unaudited pro forma results of operations for the nine months period ended September 30, 2007 of the Company as if the acquisition had taken place on January 1, 2007 including estimated purchase accounting adjustments.

(in thousands)	<b>Nine Months Ended September 30, 2007</b>
<b>REVENUES</b>	
Gross premiums and maintenance fees written	\$ 52,750
Premiums ceded	1,515
Change in unearned premiums & maintenance fees	123
Net premiums and maintenance fees earned	54,388
Investment income, net of investment expense	7,509
Realized capital gains (loss), net	(3,533)
Management service	141
Financial services	17,317
Other revenue	69
<b>Total revenues</b>	<b>75,891</b>
<b>EXPENSES</b>	
Losses and loss adjustment expenses	18,957
Other underwriting expenses	8,926
Change in deferred policy acquisition costs	(146)
Financial services expenses	15,599
General and administrative expenses	3,809
<b>Total expenses</b>	<b>47,145</b>
Income from operations	28,746



Income tax expense		10,141
Minority interests		1
Net income	\$	18,604

5.

**Investments**

**Available-For-Sale Fixed Maturities.** Our entire fixed-income portfolio consists of investment grade securities rated A or higher from any of Standard and Poor's, Moody's or Fitch with the exception of two bonds with a fair market value of approximately \$567,000. The following table reflects the composition of our fixed-income portfolio by security rating category of the issuer, as of September 30, 2008. In cases where the rating agencies had a different rating assigned to a security, the classification in the table used the lower rating.

(in thousands)			
Rating Category	Fair Value	Percentage	
AAA / Aaa	\$ 182,377	91%	
AA / Aa	9,228	5%	
A / A	7,911	4%	
Non-investment grade	567	0%	
Total	\$ 200,083	100%	

**Available-For-Sale Equity Securities.** Our equity portfolio consists of \$11,332,000 in available-for-sale equity securities as of September 30, 2008. We utilize two outside investment managers to manage our insurance segment's equity portfolio.

The amortized cost and estimated fair values of investments in fixed income and equity securities at September 30, 2008 are as follows (in thousands):

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed Maturities:				
U.S. treasury notes / bills	\$ 26,195	\$ 552	\$ 85	\$ 26,662
U.S. government agency mortgage-backed bonds	29,802	297	-	30,099
U.S. government agency collateralized mortgage obligations	55,297	641	201	55,737

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

Collateralized mortgage obligations	29,084	267	2,510	26,841
U.S. government agency bonds / notes	27,425	217	85	27,557
Government tax-exempt bonds	26,574	24	1,687	24,911
Corporate bonds	9,018	-	742	8,276
Total fixed maturities	203,395	1,998	5,310	200,083
Equity securities	12,063	262	993	11,332
Total fixed maturities and equity securities	\$ 215,458	\$ 2,260	\$ 6,303	\$ 211,415

The securities acquired as part of API were revalued to market value as of the date of the acquisition, April 1, 2007. Of our entire invested assets, including unrestricted cash as of September 30, 2008, agency-backed mortgage obligations, with underlying collateral consisting of GNMA, FHLMC, or FNMA loans comprise 37% of our portfolio; non-agency collateralized mortgage obligations ( CMO s ) comprise 12% of our portfolio; 12% is comprised of U.S. Treasury notes and bills; 26% is comprised of government agency bonds and notes, municipal tax exempt bonds and corporate bonds and the remaining 13% is cash, equities and other invested assets. The majority of the non-agency CMO s in our portfolio have underlying mortgages categorized as Prime quality loans, and none of our CMO s have underlying mortgages classified as Subprime. As of September 30, 2008, our portfolio contained seven CMO securities with collateral classified as Alternative-A or Alt-A. Alt-A securities are generally considered to have underlying mortgages with underwriting characteristics that are stronger than Subprime mortgages but less stringent than Prime mortgages. All of our Alt-A securities have underlying mortgages with fixed interest rates. All but one of our Alt-A securities are investment grade, currently rated either AA or A. During the quarter ended June 30, 2008, one of the Alt-A securities with a book value of \$44,000 at September 30, 2008 was downgraded to a B rating.

Beginning with the three months ended September 30, 2007, we saw a significant and rapid decline in the market value of our Alt-A securities. We have considered the deepening national housing crisis and its potential effects on the underlying collateral in evaluating this decline, and concluded that the decreases in value of our lowest rated Alt-A securities and one of our AA-rated Alt-A securities should be considered to be other than temporary as defined in SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. The amount of the pretax charge to earnings associated with these adjustments for the three and nine months ended September 30, 2008, was \$830,000 and \$4,598,000, respectively. The charge to earnings for the three and the nine months ended September 30, 2007 was \$3,140,000. The aggregate write-down on the Alt-A securities beginning with the quarter ended September 30, 2007 through September 30, 2008 is \$9,164,000 and the book value of all the Alt-A securities is \$4,211,000 as of September 30, 2008. While we have the ability to hold all of our Alt-A securities indefinitely, we continue to closely monitor and evaluate these securities and their underlying collateral.

During the three months ended September 30, 2008, we evaluated our equity portfolio for other than temporary impairments of certain securities. We based our review primarily on continued stock price declines of certain securities and the length of time we have held the stocks. For the three months ended September 30, 2008, the write-down in equity securities resulted in a realized loss of \$387,000. The fair value of these stocks at September 30, 2008 was \$265,000.

In 2003, we acquired 385,000 shares of common stock of Financial Industries Corporation ( FIC ). The total purchase price was approximately \$5,647,000. Our policy in regards to our investment in FIC had been that we would record pretax charges to earnings should the common stock price on the last day of each interim or annual period fall below the adjusted cost basis of our investment in FIC. From 2004 through 2007, we wrote down the carrying value of the FIC stock by \$3,414,000. On January 15, 2008, FIC announced that it had entered into an agreement and plan of merger pursuant to which it would be acquired. On July 17, 2008 that transaction closed. The basis in our investment in FIC common stock at the closing of the merger was \$5.80 per share and based on the sale price of \$7.25 per share, we recognized a \$558,000 gain in the third quarter of 2008.

Gross realized gains and losses on fixed maturity and equity securities included in the statement of operations for the three and nine month periods ended September 30, 2008 and 2007 were as follows (in thousands):

	<b>Three Months</b>		<b>Nine Months</b>	
	<b>Ended</b>		<b>Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Realized gains (losses):				

## Fixed maturities:

Gross realized gain	\$	31	\$	-	\$	161	\$	-
Gross realized loss		(830)		(3,141)		(4,601)		(3,148)
Net realized loss		(799)		(3,141)		(4,440)		(3,148)

## Equities:

Gross realized gain		843		12		916		278
Gross realized loss		(518)		(66)		(788)		(789)
Net realized loss		325		(54)		128		(511)

Total net realized loss	\$	(474)	\$	(3,195)	\$	(4,312)	\$	(3,659)
-------------------------	----	-------	----	---------	----	---------	----	---------

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

At September 30, 2008, investments with a fair market value of \$1,382,000 were on deposit with state insurance departments to satisfy regulatory requirements and these securities are included in fixed maturities, available for sale.

6.

#### **Cash Restricted**

Cash Restricted represents cash deposits advanced from a customer for a trade claim transaction that has not closed by the end of the period. At the time of receipt, Cash Restricted and Accounts Payable are increased for an equal amount as no part of this cash is ours until the transaction closes.

7.

#### **Reinsurance**

*Reinsurance Premiums Ceded.* Under our primary medical professional liability reinsurance contract or excess of loss treaty, certain premiums are ceded to other insurance companies under the terms of the reinsurance agreement. These reinsurance agreements provide us with increased capacity to write additional risk and the ability to write specific risks within our capital resources and underwriting guidelines. The excess of loss treaty provides coverage for losses in excess of API's retention of \$250,000 on individual claims and beginning in 2002, \$350,000 on multiple insured claims related to a single occurrence. The 2006 reinsurance contract provides for these same terms with API retaining 10% of the risk above the aforementioned \$250,000 and \$350,000 retention levels. The 2007 reinsurance contract provides for the same terms with API retaining 20% of the risk above the \$250,000 and \$350,000 retention levels. The 2008 reinsurance contract provides for the same terms with API retaining 40% of the risk above the \$250,000 and \$350,000 retention levels. The reinsurance contracts for 2002 through 2008 contain variable premium ceding rates based on loss experience. The ceded premium charged under these contracts will depend upon the development of ultimate losses ceded to the reinsurers under their retrospective treaties. For the three and nine months periods ended September 30, 2008, we recorded favorable development to ceded premiums of \$2,031,000 and \$5,032,000 respectively, related primarily to prior year variable premium reinsurance treaties as a result of lower estimated ultimate loss and loss adjustment expenses for treaty years 2002 through 2007. For the three and nine month periods ended September 30, 2007, we recorded favorable development to ceded premiums of \$2,435,000 and \$8,071,000 respectively. The favorable development reflects reductions in our estimates of claim severity as a result of claim closures at less than reserved amounts. During the quarter ended September 30, 2008, our ceded accrual rate for the 2008 treaty year was 14.5% of earned premium.

In addition to an adjustment to premiums ceded, estimates of ultimate reinsurance ceded premium amounts compared to the amounts paid on a provisional basis give rise to a balance sheet asset classified as Other Amounts Receivable

Under Reinsurance Contracts or a balance sheet liability classified as Funds Held Under Reinsurance Treaties. Furthermore, each retrospective treaty requires a 24 or 36 month holding period before any premium adjustments or cash can be returned or paid. The ultimate settlement amount is not determined until all losses have been settled under the respective treaties. As of September 30, 2008, we have recorded a balance sheet asset, Other Amounts Receivable Under Reinsurance Contracts of \$558,000 and a balance sheet liability, Funds Held Under Reinsurance Treaties of \$4,363,000, which represent the differences between the estimates of ultimate reinsurance premiums ceded amounts for the 2002 through 2008 treaty years as compared to the amounts paid on a provisional basis.

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

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

Reinsurance contracts do not relieve us from our obligations to policyholders. We continually monitor our reinsurers to minimize our exposure to significant losses from reinsurer insolvencies. Any amount found to be uncollectible is written off in the period in which the uncollectible amount is identified. As of September 30, 2008, all of our reinsurance contracts were with companies in strong financial condition, and we believe there is no need to establish an allowance for uncollectible reinsurance recoverables. We have not experienced any material problems collecting from our reinsurers.

Unsecured reinsurance recoverables at September 30, 2008, that exceeded 10% of total reinsurance paid and unpaid loss and loss adjustment expenses are summarized as follows (in thousands):

	<b>September 30,</b>	
<b>Company Name</b>	<b>2008</b>	
Swiss Reinsurance	\$	7,657
Transatlantic Reinsurance	\$	3,846
ACE Tempest Re USA	\$	2,551
Hannover		1,744
Ruckversicherrungs	\$	

ACE Tempest Re USA and Swiss Reinsurance are A.M. Best rated A+ (Superior). Transatlantic Reinsurance and Hannover Ruckversicherrungs are A.M. Best rated A (Excellent).

8.

**Reserve for Loss and Loss Adjustment Expense**



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

We write medical malpractice insurance policies which have a lengthy period for reporting a claim (tail coverage) and a long process of litigating a claim through the courts and whose risk factors expose our reserves for loss and loss adjustment expenses to significant variability. These conditions subject our open reported claims and incurred but not reported claims to increases due to inflation, changes in legal proceedings and changes in the law. While the anticipated effects of inflation is implicitly considered when estimating reserves for loss and loss adjustment expenses, an increase in average severity of claims is caused by a number of factors. Future average severities are projected based on historical trends adjusted for changes in underwriting standards, policy provisions and general economic trends. Those anticipated trends are monitored based on actual experience and are modified as necessary to reflect any changes in the development of ultimate losses and loss adjustment expenses. These specific risks, combined with the variability that is inherent in any reserve estimate, could result in significant adverse deviation from our carried reserve amounts. Settlement of claims is subject to considerable uncertainty. We believe the reserves for loss and loss adjustment expenses are reasonably stated as of September 30, 2008.

We recorded \$11,347,000 for losses and loss adjustment expenses for the nine months ended September 30, 2008, which included \$28,862,000 for the current accident year, reduced by \$17,515,000 of favorable development for prior report years. The favorable development was primarily the result of loss severity for the 2003 through 2007 report years developing favorably compared to prior period estimates. In addition, the total number of claims closed with indemnity for these report years were less than prior estimates.

9.

**Contingencies**

We are involved in various claims and legal actions that arise in the ordinary course of business. One of our subsidiaries, APS Capital Corporation ( APS Capital ), is currently party to litigation regarding a disputed bankruptcy trade claim. We believe that the disposition of these matters will not have a material adverse affect on our consolidated financial position, results of operation or cash flows.

10.

**Earnings Per Share**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(in thousands, except for per share data)</b>			
<b>Numerator for basic and diluted income per common share:</b>				
Net income before extraordinary gain	\$ 7,183	\$ 5,292	\$ 16,709	\$ 15,004
Extraordinary gain, net of tax	-	-	-	2,264
Net income	\$ 7,183	\$ 5,292	\$ 16,709	\$ 17,268
<b>Denominator:</b>				
Denominator for basic income per common share				
weighted average shares outstanding	7,134	7,107	7,160	4,977
Effect of dilutive stock options and awards	110	146	126	137
Denominator for diluted income per common share	7,244	7,253	7,286	5,114

adjusted weighted average shares outstanding

<b>Net income - basic</b>	\$	1.01	\$	0.74	\$	2.33	\$	3.47
<b>Net income - diluted</b>	\$	0.99	\$	0.73	\$	2.29	\$	3.37

## 11.

**Segment Information**

The Company's segments are distinct by type of service provided. Comparative financial data for the three and nine month periods ended September 30, 2008 and 2007 are shown as follows:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Operating revenue:				
Insurance services	\$ 16,956	\$ 16,720	\$ 49,934	\$ 43,219
Financial services	1,675	5,660	5,167	18,023
All other	3,320	1,077	6,454	1,729
Total segment revenues	\$ 21,951	\$ 23,457	\$ 61,555	\$ 62,971
Reconciliation to consolidated statement of operations:				
Total segment revenues	\$ 21,951	\$ 23,457	\$ 61,555	\$ 62,971
Less: intercompany dividends	(2,065)	(578)	(4,214)	(1,353)
Total revenues	\$ 19,886	\$ 22,879	\$ 57,341	\$ 61,618
Operating income:				
Insurance services	\$ 11,880	\$ 9,278	\$ 30,471	\$ 24,954
Financial services	(452)	753	(2,846)	2,424
All other	(247)	(1,109)	(1,981)	(3,424)
Total segment operating income	\$ 11,181	\$ 8,922	\$ 25,644	\$ 23,954
Income tax expense	3,998	3,630	8,935	8,949
Minority interest	-	-	-	1
Income from operations before	7,183	5,292	16,709	15,004

extraordinary gain

Extraordinary gain, net of taxes	-	-	-	2,264
Net income	\$ 7,183	\$ 5,292	\$ 16,709	\$ 17,268

Capital expenditures:

Insurance services	\$ 35	\$ 202	\$ 332	\$ 624
Financial services	-	22	28	52
All other	35	17	368	34
	\$ 70	\$ 241	\$ 728	\$ 710

**September 30,**

**2008**

Balance sheet data:

Identifiable assets:

Insurance services	\$ 233,880
Financial services	2,111
All other	48,826
	\$ 284,817

12.

### **Stock-Based Compensation**

We use the Black-Scholes-Merton option-pricing model to determine the fair value of stock-based awards. For the three months ended September 30, 2008, we recorded compensation cost related to stock options of \$157,000 and a related reduction in income taxes of \$55,000. For the nine months ended September 30, 2008, we recorded compensation cost related to stock options of \$477,000 and a related reduction in income taxes of \$167,000. The compensation cost is the total fair value, at date of grant, of stock options that vested during the period. No compensation costs were capitalized in the three and nine month periods ended September 30, 2008.

During the three months ended September 30, 2008, 37,000 options were exercised with an intrinsic value of \$362,000. During the nine months ended September 30, 2008, 131,000 options were exercised with an intrinsic value of \$1,468,000. For the three and nine months ended September 30, 2008, we received cash proceeds of \$0 and \$84,000, respectively. For the three and nine months ended September 30, 2008, we received \$402,000 and \$1,196,000, respectively, in value through cashless exercises/exchanges for the options exercised. Also as of September 30, 2008, there was \$972,000 of total unrecognized compensation cost related to non-vested shares under our 2005 Incentive and Non-Qualified Stock Option Plan ("2005 Stock Option Plan"), which is expected to be recognized over a weighted-average period of 1.4 years.

The 2005 Stock Option Plan provides for the issuance of up to 1,250,000 shares of common stock to our directors and key employees. A total of 787,000 of these options have been granted as of September 30, 2008 and 463,000 are available for grants. Of those granted, 30,000 shares have been exercised, 376,000 options are exercisable and 381,000 are not yet exercisable. As of September 30, 2008, we still have exercisable options for 66,000 shares outstanding from our previous plan, the 1995 Incentive and Non-Qualified Stock Option Plan .

The exercise price for each non-qualified option share is determined by the Compensation Committee of the Board of Directors (the Committee ). The exercise price of a qualified incentive stock option has to be at least 100% of the fair market value of such shares on the date of grant of the option. Under the Plans, option grants are limited to a maximum of ten-year terms; however, the Committee has issued all currently outstanding grants with five-year terms. The Committee also determines vesting for each option grant and traditionally has had options vest in two to three approximately equal annual installments beginning one year from the date of grant.

Presented below is a summary of the stock options held by our employees and our directors and the related transactions for the three and nine months ended September 30, 2008.

	<b>Three Months Ended September 30, 2008</b>			<b>Nine Months Ended September 30, 2008</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>		<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Balance at July 1	718,000	\$ 14.89	Balance at January 1	813,000	\$ 14.89
Options granted	143,000	20.50	Options granted	143,000	20.50
Options exercised	37,000	10.88	Options exercised	131,000	9.73
Options forfeited/expired	-	-	Options forfeited/expired	1,000	19.43
Balance at September 30	824,000	\$ 16.04	Balance at September 30	824,000	\$ 16.04
Options exercisable	443,000	\$ 13.62	Options exercisable	443,000	\$ 13.62

The weighted average fair value of Company stock options granted is \$3.02 per option for the nine months ended September 30, 2008. The fair value of the options was calculated using the Black-Scholes-Merton option pricing model with the following assumptions:

	<b>Nine Months Ended September 30, 2008</b>
Expected option term	3.7 years
Expected volatility	17.59%
Expected dividend yield	1.46%
Risk-free rate of return	2.74%

The expected volatility assumptions we used are based on the historical volatility of our common stock over the most recent period commensurate with the estimated expected life of our stock options, such estimated life being based on the historical experience of our stock option exercises.

The following table summarizes our outstanding and exercisable options at September 30, 2008:

<b>Stock Options Outstanding</b>				<b>Stock Options Exercisable</b>			
<b>Weighted</b>		<b>Average</b>		<b>Weighted</b>		<b>Average</b>	
<b>Average</b>	<b>Aggregate</b>	<b>Remaining</b>	<b>Contractual</b>	<b>Average</b>	<b>Aggregate</b>	<b>Remaining</b>	<b>Contractual</b>
<b>Exercise</b>	<b>Intrinsic</b>			<b>Exercise</b>	<b>Intrinsic</b>		
<b>Shares</b>	<b>Price</b>	<b>Value (1)</b>	<b>Life</b>	<b>Shares</b>	<b>Price</b>	<b>Value (1)</b>	<b>Life</b>
824,000	\$ 16.04	\$ 4,234,000	3.4	443,000	\$ 13.62	\$ 3,346,000	2.7

(1)

Based on the \$21.18 closing price of our stock at September 30, 2008.



13.

**Secondary Stock Offering**

On June 19, 2007, we announced that our public offering of 2,100,000 shares of common stock had priced at \$16.50 per share. Of the shares sold, 2,000,000 were offered by us, and Kenneth S. Shifrin, our Chairman of the Board and Chief Executive Officer, offered 100,000 of the 582,554 shares he owned at that date.

Pursuant to the secondary offering, the underwriters of the offering were granted a 30-day period to exercise an option to purchase up to 315,000 additional common shares from us at the public offering price of \$16.50 per share. In July 2007, the underwriters exercised the full over-allotment option.

Net proceeds received by us from the secondary offering, including the over-allotment, were approximately \$35,000,000 after deducting underwriting, legal, accounting, and publication fees. Of this total, we contributed \$10,000,000 to API to strengthen its capacity to underwrite insurance risks. The balance of the proceeds has been invested primarily in U.S. government and U.S. government agency securities and is available for general corporate purposes including possible acquisitions.

14.

**Mandatorily Redeemable Preferred Stock**

In conjunction with the acquisition of API we issued 10,198 shares of Series A redeemable preferred stock, par value \$1.00 per share, from the 10,500 shares authorized. Holders of Series A redeemable preferred stock are entitled to cumulative dividends thereon at the rate of three percent (3%) per annum payable on the remaining redemption value per share, in priority to the payments of dividends on the common shares. Holders of our Series A redeemable preferred stock have no preemptive rights and have the same voting rights as the holders of our common stock. The shares are non-certificated and mandatorily redeemable. They must be redeemed ratably at not less than \$1,000,000 per year, with all remaining outstanding shares being redeemed by December 31, 2016. In June 2007, 1,019 shares of our Series A redeemable preferred stock were redeemed for \$1,058,000, which included accrued dividends of \$40,000. In June 2008, 1,004 shares of our Series A redeemable preferred stock were redeemed for \$1,302,000, which included accrued dividends of \$297,000. Amortized interest on the outstanding balance totaled \$282,000. In the event of any liquidation, the holders of our Series A redeemable preferred stock receive an amount equal to the remaining redemption value before any distribution is made to the holders of our common stock.

Pursuant to Financial Accounting Standards Board ( FASB ) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ( FASB No. 150 ), an issuer is required to classify an instrument as a liability if it is issued in the form of shares that are mandatorily redeemable if it embodies an unconditional obligation that requires the issuer to redeem the shares by transferring the entity's assets at a specified or determinable date(s) or upon an event that is certain to occur. The preferred stock's mandatory cash redemption feature coupled with a fixed redemption date and fixed amount requires that it be classified as debt, rather than equity. In addition, the preferred stock dividend has been classified as interest expense. As of September 30, 2008, the fair market value of the Series A redeemable preferred stock was \$7,477,000, based on the outstanding balance of \$8,087,000 discounted at 5.35%.

15.

**Minority Interest**

The 3% minority interest in Asset Management, a subsidiary within our financial services segment, owned by key individuals within Asset Management, was repurchased by APS Investment Services in the quarter ended September 30, 2007 for a nominal amount.

16.

**Income Taxes**

The provision for income taxes is based on amounts reported in the statements of income after exclusion of nontaxable income such as interest on state and municipal securities. Also, certain items of income and expenses are recognized in different time periods for financial statement purposes than for income tax purposes. Thus, provisions for deferred taxes are recorded in recognition of such temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. The Company and its subsidiaries file a consolidated federal income tax return. Consolidated income tax expense is allocated on the basis of each company's income adjusted for permanent differences.

On January 1, 2007, the Company adopted the provision of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement No. 109, *Accounting for Income Taxes*. The Company does not believe it has any unrecognized tax benefits included in its consolidated financial statements. The Company has not recognized any interest or penalties in the consolidated financial statements, nor has it recorded an accrued liability for interest or penalty payments.

Our effective income tax rate for the three and nine months ended September 30, 2008 was approximately 35.8% and 34.8%, respectively. Our effective income tax rate for the three and nine months ended September 30, 2007 was approximately 40.7% and 37.4%, respectively.

17.

**Fair Value Measurements**

In September 2006, the Financial Accounting Standards Board issued SFAS 157, *Fair Value Measurements*. SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. Under the standard, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts its business. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. Our assessments with respect to assumptions that market participants would make are inherently difficult to determine and use of different assumptions could result in material changes to these fair value measurements. Effective January 1, 2008, the Company adopted the provisions of SFAS 157 as it relates to financial assets and financial liabilities. The adoption of SFAS 157 did not have a material effect on our results of operations, financial position or liquidity.

Fair value is used on a recurring basis for our equity and fixed maturity, available for sale securities in which fair value is the primary basis of accounting. Fair value for these securities is the market value based on quoted market prices, when available (Level 1) or quoted prices for similar assets or liabilities in active markets or market prices obtained from third-party pricing services for identical or comparable assets (Level 2). Certain assets and liabilities are not actively traded in observable markets with listed prices or quotes and we must use alternative valuation techniques based on independent dealer quotes on the security and our own assumptions and professional judgment to derive a fair value measurement (Level 3). In these instances when significant valuation assumptions are not readily observable in the market, instruments are valued based on the best available data to approximate fair value. This data would consider a risk premium that a market participant would require. We use prices and inputs that are current as of the measurement date, including periods of market dislocation. Typically, during periods of market dislocation, the observability of prices and inputs may be reduced for the instruments we hold. This condition could cause an instrument to be reclassified to a lower level during any given period.

The following table presents the estimated fair value of our financial instruments on a recurring basis as of September 30, 2008:

(in thousands)	Fair Value Measurements at September 30, 2008			
	Description	September 30,	Using:	
Quoted prices in active			Significant other	Significant other

	<b>2008</b>	<b>markets for</b>	<b>observable</b>	<b>unobservable</b>
		<b>identical</b>	<b>inputs</b>	<b>inputs</b>
		<b>assets</b>	<b>Level 2</b>	<b>Level 3</b>
		<b>Level 1</b>		
Financial Assets:				
Fixed income securities, available for sale	\$ 200,083	\$ 26,663	\$ 170,734	\$ 2,686
Equity securities, available for sale	11,332	11,277	55	-
Total	\$ 211,415	\$ 37,940	\$ 170,789	\$ 2,686

A reconciliation of the beginning and ending balances of our financial instruments for fair value measurements made using significant unobservable inputs (Level 3) follows (in thousands):

	<b>Fixed Maturity Securities, Available for Sale</b>
Balance, January 1, 2008	\$ 11,867
Total gains or losses realized/unrealized:	
Included in earnings (or changes in net assets)	(3,429)
Included in other comprehensive income	249
Purchases, issuances, and settlements	(2,341)
Transfers in and/or out of Level 3	(3,660)
Balance, September 30, 2008	\$ 2,686
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008	\$ (3,564)
Gains and losses (realized and unrealized) included in earnings for the period are reported in net realized investment gains (losses) as follows:	
Total gains or losses included in earnings for the period (above)	\$ (3,436)
Change in unrealized gains or losses related to assets held at September 30, 2008	\$ 34

In estimating the fair values for our equity securities and U.S. Treasury fixed maturity securities, since there is an active, readily tradable market value based on quoted prices, we base our estimates on such prices (Level 1 pricing) as of September 30, 2008, or the measurement date. Active markets are those in which transactions occur in significant frequency and volume to provide pricing information on an on-going basis. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these securities does not entail a significant degree of judgment.

For Level 2 pricing if quoted market prices in active markets are not available on the securities we own, fair values are based on the market prices of similar instruments or are estimated using independent pricing services where valuations are based on industry-standard models such as matrix pricing. Level 2 pricing includes our fixed maturity securities that are valued by our independent pricing service using proprietary models or valuation methodologies. Since fixed maturities other than U.S. treasury securities and certain government obligations do not trade on an daily basis, the pricing service prepares estimates of fair value measurements for these securities based on market inputs including, but not limited to, benchmark curves, reported trades, broker/dealer quotes, issuer spreads, benchmark securities, quoted forward prices, time value, volatility factors, current market and contractual prices for the underlying instrument, and industry news and economic events. The extent of the use of each market input depends on the asset class and the market conditions.

Valuations of fixed maturity securities obtained from independent pricing services are reviewed for reasonableness based upon the specifics of the security, including class, maturity, credit rating, durations, collateral, and comparable markets for similar securities. We may adjust the valuation of securities from these independent pricing services when we believe their pricing does not fairly represent the market value of the investment. When market observable data is not as readily available or if the security trades in an illiquid market, the valuation of financial instruments becomes more subjective and could involve substantial judgment resulting in Level 3 pricing. For example, this may occur in the valuations provided by independent pricing services in their pricing of certain mortgage-backed securities, including our Alt-A securities. The pricing of these securities can be influenced by specific characteristics such as the overall structure of the instrument; default rates; demographic and geographic characteristics of the underlying mortgages; support levels; loan to value ratios; and other specific factors underlying these investments. In order to reflect the fair market value for these securities, we evaluate independent pricing and may adjust these prices based on independent dealer quotes and/or the judgment of the securities professionals in our financial services segment. As of September 30, 2008, we have adjusted all remaining Alt-A securities to lower market values from that indicated by independent pricing services based on indications from dealers which we believe is more reflective of the current sales price of these securities and the ultimate realizable value and accordingly, these securities are included in Level 3 pricing. For the three and nine months ended September 30, 2008, we recognized \$830,000 and \$4,598,000 of realized losses based on Level 3 pricing assumptions on our lowest rated Alt-A securities. As of September 30, 2008, our Alt-A portfolio based on level 3 pricing assumptions approximates only 1.4% of our total investment portfolio, including unrestricted cash. See Note 5 to the financial statements included herein for additional discussion regarding our Alt-A write-downs.

## **ITEM 2.**

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

For purposes of this Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), APS, we, our, us and the Company refer to American Physicians Service Group, Inc., together with its subsidiaries, unless the context requires otherwise. The following MD&A should be read in conjunction with the accompanying consolidated financial statements for the three and nine months ended September 30, 2008, included in Part I, Item 1, As well as the audited, consolidated financial statements and notes in our Annual Report on Form 10-K for the year ended December 31, 2007, which was filed with the United States Securities and Exchange Commission (the SEC) on March 13, 2008.

### **CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This quarterly report contains forward-looking statements within the meaning of Section 27A of the Securities Act, Section 21E of the Exchange Act and the Private Securities Litigation Reform Act of 1995, about the Company that



are subject to risks and uncertainties. All statements other than statements of historical fact included in this document are forward-looking statements.

You can identify forward-looking statements by the use of words such as may, target, should, could, estimate, predicts, potential, continue, anticipates, projects, forecasts, believes, plans, expects, future and other expressions which are intended to identify forward-looking statements. Forward-looking statements are based on beliefs and assumptions made by management using currently available information, such as market and industry materials, experts' reports and opinions and trends. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors, some of which are beyond our control and difficult to predict and could cause actual results to differ materially from those expressed or forecasted in the forward-looking statements. In evaluating forward-looking statements, you should carefully consider the risks and uncertainties referenced in Risk Factors in Part II, Item IA. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors contained in this quarterly report. Forward-looking statements contained in this quarterly report reflect our view only as of the date of this report. We do not have any obligation, other than as required by law, to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following important factors, in addition to those referenced under Risk Factors in Part II, Item 1A, could affect the future results of our operations and could cause those results to differ materially from those expressed in or implied by such forward-looking statements:

general economic conditions, either nationally or in our market area, that are worse than expected;

changes in the healthcare industry;

regulatory and legislative actions or decisions that adversely affect our business plans or operations;

inflation and changes in the interest rate environment, the performance of financial markets and/or changes in the securities markets;

uncertainties inherent in the estimate of loss and loss adjustment expense reserves and reinsurance; changes in the availability or cost of reinsurance;

significantly increased competition among insurance providers;

potential losses and litigation risk associated with our financial services businesses;

loss of key executives, personnel, accounts or customers;

our ability to renew our existing reinsurance or obtain new reinsurance; and

failure of our reinsurers to pay claims in a timely manner.

The foregoing factors should not be construed as exhaustive and we caution you not to place undue reliance on forward-looking statements, which speak only as of the date of this quarterly report. In addition to any risks and uncertainties specifically identified in the text surrounding forward-looking statements, you should consult with our other filings under the Securities Act of 1933 and the Securities Act of 1934, for factors that could cause our actual results to differ materially from those presented.

## **Business Overview**

We provide (1) insurance services, specifically medical professional liability insurance in Texas, Arkansas and Oklahoma and (2) financial services, including brokerage and investment services to individuals and institutions.

*Insurance Services.* We provide medical professional liability insurance primarily in Texas, where our insurance subsidiary, API, has written business for over 30 years. API is authorized to do business in the States of Texas, Arkansas and Oklahoma and specializes in writing medical professional liability insurance for physicians, dentists and other healthcare providers. API currently insures approximately 5,200 physicians, dentists, and other healthcare providers, the vast majority of which are in Texas. Approximately 97% of API's premiums are written through purchasing groups, which in Texas currently subjects us to less stringent state regulation of premium rates and policy forms. Historically, we operated as the attorney-in-fact manager for API since 1975. In April 2007, we acquired API, thus combining our insurance management experience with an insurance underwriting entity to allow for the increased possibility for expansion into new markets and to assist our efforts for continued growth in existing markets.



*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 commission revenue, and the related compensation expense, on a trade date basis.

o

APS Capital. APS Capital is dedicated to the clearing and settlement of trades involving non-securities including syndicated bank loans, trade claims and distressed private loan portfolios. We seek to develop business with clients who trade in distressed markets. We recognize commission revenue, and the related compensation expense, when the transaction is complete and fully funded.

o

APS Asset Management. APS Asset Management, a registered investment adviser under the Investment Advisers Act of 1940, 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.

## **Recent Transactions**

Acquisition. On April 1, 2007, we acquired all of the issued and outstanding stock of API. The business combination is being accounted for using the purchase method of accounting and, accordingly, the purchase price has been allocated to assets acquired and liabilities assumed based on fair values at the date of acquisition. The total purchase price was \$45,167,000 and consisted of consideration of 1,982,499 shares of the Company's common stock, valued at a per share price of \$17.635, or \$34,961,000 in aggregate, \$35,000 in cash paid in lieu of fractional shares of common stock, 10,197.95 shares of preferred stock valued at \$9,179,000, plus costs to complete the acquisition of \$992,000. We are required to redeem at least \$1 million of the preferred stock each calendar year beginning in 2007, until December 31, 2016, at which time all of the preferred stock must have been redeemed. The preferred stock has a cumulative dividend equal to 3% of the outstanding redemption value per year. In June 2007, 1,019 shares of our Series A redeemable preferred stock were redeemed for \$1,058,000, which included accrued dividends of \$40,000. In June 2008, 1,004 shares of our Series A redeemable preferred stock were redeemed for \$1,302,000, which included

accrued dividends of \$297,000. In the event of any liquidation, the holders of our Series A redeemable preferred stock receive an amount equal to the remaining redemption value before any distribution is made to the holders of our common stock.

Secondary Stock Offering. On June 19, 2007 we announced that our public offering of 2,100,000 shares of common stock had priced at \$16.50 per share. Of the shares sold, 2,000,000 were offered by us, and Kenneth S. Shifrin, our Chairman of the Board and Chief Executive Officer, offered 100,000 of the 582,554 shares he owned at that date.

Pursuant to the secondary offering, the underwriters of the offering were granted a 30-day period to exercise an option to purchase up to 315,000 additional common shares from us at the public offering price of \$16.50 per share. In July 2007, the underwriters exercised the full over-allotment option.

Net proceeds received by the Company from the secondary offering, including the over-allotment, were approximately \$35,000,000 after subtracting underwriting, legal, accounting and publication fees. Of this total, we contributed \$10,000,000 to API to strengthen its capacity to underwrite insurance risks. The balance of the proceeds has been invested primarily in U.S. government and U.S. government agency securities and is available for general corporate purposes including possible acquisitions.

## Critical Accounting Policies and Estimates

Except for the following critical accounting policy related to the adoption of SFAS 157, effective January 1, 2008, the accounting policies considered by management to be critically important in the preparation and understanding of the financial statements and related disclosures are presented in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the year ended December 31, 2007.

*Fair Value Measurements.* In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 157, *Fair Value Measurements*. SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. Under the standard, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts its business. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy.

Effective January 1, 2008, we adopted SFAS 157, *Fair Value Measurements*, for our financial assets and financial liabilities, but have not yet adopted SFAS 157 as it relates to nonfinancial assets and liabilities based on the February 2008 issuance of FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157*, which permits a one-year deferral of the application of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 as it pertains to financial assets and liabilities did not have a material impact on our results of operations, financial position or liquidity. We will adopt FAS 157 for non-financial assets and non-financial liabilities on January 1, 2009 and do not expect the provisions to have a material effect on its results of operations, financial position or liquidity.

The standard describes three levels of inputs that may be used to measure fair value:

### Level 1

Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

### Level 2

Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

### **Level 3**

Valuations are developed from unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

When determining the fair value measurements for assets and liabilities required or permitted to be recorded at and/or marked to fair value, we consider the principal or most advantageous market in which it would trade and consider assumptions that market participants would use when pricing the asset or liability. When possible, we look to active and observable markets to price identical assets or liabilities. When identical assets and liabilities are not traded in active markets, we look to market observable data for similar assets and liabilities, independent industry-standard models such as matrix pricing and independent, third-party dealer quotes whose inputs may be less observable than Level 1 pricing. When market observable data is not as readily available, the valuation of financial instruments becomes more subjective and could involve substantial judgment. Certain assets and liabilities are not actively traded in observable markets and the Company must use alternative valuation techniques to derive a fair value measurement. For additional disclosures, see Note 17, *Fair Value Measurements*, to the unaudited financial statements included herein.



### **Unaudited Pro Forma Condensed Consolidated Financial Information**

We are providing the following unaudited pro forma condensed consolidated financial statements to present the results of operations of the combined company after giving effect to our acquisition of API, absent any operational or other changes, as if API's and our businesses had been combined for the periods and at the dates indicated. The pro forma condensed consolidated statements of operations for the nine months ended September 30, 2007 are presented as if the API acquisition occurred on January 1, 2007. The unaudited pro forma condensed consolidated financial statements were prepared using the purchase method of accounting. We recognized equity compensation costs of approximately \$1.2 million related to our acquisition of API in the nine months ended September 30, 2007, which resulted in a one-time decrease in net income for that period.

The pro forma adjustments are based upon available information and assumptions that we believe are reasonable. The unaudited pro forma condensed consolidated financial statements are presented for illustrative purposes only and are based on the estimates and assumptions set forth in the notes accompanying these statements, which should be read in conjunction with these unaudited pro forma condensed consolidated financial statements. The companies may have performed differently had they always been combined. You should not rely on this information as being indicative of the historical results that would have been achieved had the companies always been combined or the future results that the combined company will experience. The unaudited pro forma condensed consolidated financial information is not comparable to our historical financial information due to the inclusion of the effects of the API acquisition. The unaudited pro forma condensed consolidated financial statements and the related notes thereto should be read in conjunction with the unaudited consolidated financial statements of the Company for the nine months ended September 30, 2007, and the related notes thereto and other information included herein. The unaudited financial statements of API for the three months ended March 31, 2007 are included in the Form S-1 filed by the Company dated June 19, 2007.

**Unaudited Pro Forma Condensed Combined Statement of Operations**

**For the Nine Months Ended September 30, 2007**

(In thousands, except per share data)

	<b>API</b>	<b>APSG</b>	<b>Pro Forma</b>	<b>Combined</b>
	<b>Historical</b>	<b>Historical</b>	<b>Adjustments</b>	<b>Pro Forma</b>
	<b>3-31-07</b>	<b>9-30-07</b>	<b>Merger</b>	<b>9-30-07</b>
			<b>(Note 4)</b>	
<b>REVENUES</b>				
Premiums and maintenance fees written	\$ 15,466	\$ 37,284	\$ -	\$ 52,750
Premiums ceded	(2,407)	3,922		1,515
Change in unearned premiums & maintenance fees	3,252	(3,129)		123
Net Premiums and maintenance fees earned	16,311	38,077		54,388
Investment income, net of investment expense	1,791	5,743	78 (a) (117) (d) 14 (b)	7,509
Realized capital gains (losses), net	126	(3,659)		(3,533)
Management services	-	3,765	(3,718) (a) 94 (c)	141
Financial services	-	17,623	(306) (b)	17,317
Other revenue	-	69		69
<b>Total revenues</b>	<b>18,228</b>	<b>61,618</b>	<b>(3,955)</b>	<b>75,891</b>
<b>EXPENSES</b>				
Losses and loss adjustment expenses	10,934	7,786	(1,001) (a) 1,238 (d)	18,957
Other underwriting expenses	3,214	5,696	1,572 (d) (1,650) (a) 94 (c)	8,926
Change in deferred policy acquisition costs	141	(287)		(146)

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

Management services expenses	-	3,823	(3,823) (f)	-
Financial services expenses	-	15,599		15,599
General and administrative	-	3,800	(989) (a)	3,809
			(2,927) (d)	
			102 (e)	
			3,823 (f)	
<b>Total expenses</b>	14,289	36,417	(3,561)	47,145
				-
Income (loss) from operations	3,939	25,201	(394)	28,746
Income tax expense (benefit)	1,326	8,949	(35) (e)	10,141
			(99) (b)	
Minority interests		1		1
Net income (loss)	\$ 2,613	\$ 16,251	\$ (260)	\$ 18,604
<b>Net Income per Share:</b> (Note 10)				
Basic			\$	3.74
Diluted			\$	3.64
Basic weighted average shares outstanding				4,977
Diluted weighted average shares outstanding				5,114

**Notes to Unaudited Pro Forma Condensed**

**Consolidated Financial Statements**

**1.**

**Basis of Presentation**

The accompanying unaudited pro forma statements of operations present the pro forma effects of our acquisition of API through the issuance of common and preferred shares of our stock. The statement of operations for the nine months ended September 30, 2007 is presented as though the acquisition occurred on January 1, 2007.

**2.**

**Method of Accounting for the Acquisition**

We accounted for the acquisition using the purchase method of accounting for business combinations. We were deemed to be the acquirer for accounting purposes based on a number of factors determined in accordance with GAAP. The purchase method of accounting requires that API's assets acquired and liabilities assumed by us be recorded at their estimated fair values.

**3.**

**Adjustments to Historical Financial Statements for Comparability**

Following the acquisition, we are primarily an insurance company and, accordingly, we have reclassified our statement of operations in the unaudited pro forma financial information to conform to GAAP as applied to insurance companies.

**4.**

**Pro Forma Adjustments Related to the Acquisition**

Pursuant to our acquisition of API, API became a wholly owned subsidiary of the Company.

At the effective time of the acquisition, April 1, 2007, each share of common stock of API was converted into, and exchanged for, the right to receive the number of shares of our common stock based upon an exchange ratio equal to a purchase price of \$45 million minus the \$9,179,000 agreed-upon present value of the payments authorized by the Texas Department of Insurance that must be made by us to comply with the mandatory redemption features of the API Series A redeemable preferred stock in exchange for the API refundable deposit certificates, divided by \$17.28, divided by the 10,000,000 shares of API common stock. The \$17.28 price was the average closing price of our common shares for the twenty trading days immediately preceding the closing. According to the terms of the merger agreement for the acquisition, the value of our common stock issued in the acquisition was subject to adjustment upwards or downwards by up to 15% based on the closing price of our common shares for the twenty trading days immediately preceding the effective date of the acquisition.

Each share of Series A redeemable preferred stock of API was converted into the right to receive one share of our Series A redeemable preferred stock. The shares of our common stock and Series A redeemable preferred stock issued in the acquisition were subject to a 180-day lock-up period in which the holders of such shares were prohibited from transferring their shares. This lock-up period expired on September 28, 2007.

The purchase accounting and pro forma adjustments related to unaudited pro forma balance sheet and statements of operations as a result of the acquisition are as follows:

(a)

Records the elimination of the revenue component of management fee and sub-producer commissions by the Company, the management fee expense by API and the sub-producer expenses by the Company for the three months ended March 31, 2007.

(b)

Records the elimination of intercompany revenue by APS Investment Services for investment trading fees for managing API's fixed income investment portfolio and records related other comprehensive income at API, change in amortization of bond premium and tax expense. The net effect on retained earnings is a reduction of \$193,000 for the three months ended March 31, 2007.



(c)

Records commission expense incurred by API that is currently reimbursed by the Company. There is no reimbursement following the acquisition. The reimbursement was eliminated in our financial statements.

(d)

Reclassifies the salaries, marketing, professional fees and general administrative expenses of the attorney-in-fact.

(e)

Records the 3% per annum dividend on our Series A redeemable preferred stock and the imputed interest from recording the liability at fair value.

(f)

Reclassifies management services expenses to general and administrative expenses.

## **Results of Operations**

With the acquisition of API on April 1, 2007, our consolidated revenue and earnings are now predominately derived from medical professional liability insurance provided through our Insurance Services segment. Prior to April 1, 2007, the historical results of operations of our Insurance Services segment were determined by the management fees we received from API pursuant to a management agreement and the expenses incurred in managing API's operations such as personnel expenses, rent, office expenses and technology costs. The management agreement obligated API to pay management fees to us based on API's earned premiums before payment of reinsurance premiums. The management fee percentage was 13.5% of API's earned premiums. In addition, any pre-tax profits of API were shared equally with us (profit sharing) so long as the total amount of profit sharing did not exceed 3% of earned premiums. When we acquired API, our management agreement with API was terminated and our consolidated results of operations are no longer affected by management fees from API; but, rather our results of operations are now directly affected by premiums API earns from the sale of medical professional liability insurance, investment income earned on assets held by API, insurance losses and loss adjustment expenses relating to the insurance policies API writes as well as commissions and other insurance underwriting and policy acquisition expenses API incurs.

The following table sets forth selected historical financial and operating data for the Company. Our results of operations for the three and nine months ended September 30, 2008 and 2007 includes the historical financial and operating results of the Company prior to and subsequent to the acquisition of API on April 1, 2007. The selected income statement data below for the three and nine months ended September 30, 2008 and 2007, is derived from our consolidated unaudited financial statements which management believes incorporate all of the adjustments necessary for the fair presentation of the financial condition and results of operations for such periods. Equity compensation expense of approximately \$1,200,000 related to our acquisition of API is included in nine months ended September 30, 2007 results from operations. Actual financial results through September 30, 2008 may not be indicative of future financial performance. Certain Non-GAAP financial measures are included in the underwriting ratio section table below as these ratios represent insurance industry-specific financial performance measures.

For comparative purposes, we have also included on a pro forma basis the results of operations for the nine months ended months ended September 30, 2007 of the Company and API as if the acquisition had occurred on January 1, 2007. Any reference in the MD&A Section below to on a pro forma basis is as if the Company acquired API on January 1, 2007.



**Selected Condensed Consolidated Historical and Pro Forma Financial and  
Operating Data of American Physicians Service Group, Inc.**

(in thousands, except share, per share and ratio data)	<b>Three Months</b>			<b>Nine Months</b>	
	<b>Ended</b>			<b>Ended</b>	
	<b>September 30,</b>			<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>	<b>2007</b>
	<b>Actual</b>	<b>Actual</b>	<b>Actual</b>	<b>Actual</b>	<b>Proforma</b>
<b>Income Statement Data:</b>					
Gross premiums and maintenance fees written - direct and assumed	\$ 21,246	\$ 22,239	\$ 51,106	\$ 37,284	\$ 52,750
Premiums ceded	711	504	1,087	3,922	1,515
Net premiums and maintenance fees written	21,957	22,743	52,193	41,206	54,265
Net premiums and maintenance fees earned	15,709	17,631	47,657	38,077	54,388
Investment income, net of investment expenses	2,996	2,904	9,011	5,743	7,509
Realized capital gains (losses) - net	(474)	(3,195)	(4,312)	(3,659)	(3,533)
Management services	42	70	63	3,765	141
Financial services	1,558	5,434	4,835	17,623	17,317
Other revenue	55	35	87	69	69
<b>Total revenues</b>	<b>19,886</b>	<b>22,879</b>	<b>57,341</b>	<b>61,618</b>	<b>75,891</b>
Losses and loss adjustment expenses	2,259	4,624	11,347	7,786	18,957
Other underwriting expenses	3,220	3,262	8,322	5,696	8,926
Change in deferred acquisition costs	(403)	(444)	(206)	(287)	(146)
Management services expenses	-	-	-	3,823	-
Financial services expenses	2,127	4,907	8,013	15,599	15,599
General and administrative expenses	1,502	1,608	4,221	3,800	3,809
Impairment of goodwill	-	-	-	1,247	-
<b>Total expenses</b>	<b>8,705</b>	<b>13,957</b>	<b>31,697</b>	<b>37,664</b>	<b>47,145</b>
<b>Income from operations</b>	<b>11,181</b>	<b>8,922</b>	<b>25,644</b>	<b>23,954</b>	<b>28,746</b>
Income tax expense	3,998	3,630	8,935	8,949	10,141
Minority Interests	-	-	-	1	1

<b>Net income before extraordinary gain</b>	7,183	5,292	16,709	15,004	18,604
Extraordinary gain	-	-	-	2,264	-
<b>Net income</b>	<b>\$ 7,183</b>	<b>\$ 5,292</b>	<b>\$ 16,709</b>	<b>\$ 17,268</b>	<b>\$ 18,604</b>
Diluted weighted average shares outstanding	7,244	7,253	7,286	5,114	5,114
Diluted earnings per common share	<b>\$ 0.99</b>	<b>\$ 0.73</b>	<b>\$ 2.29</b>	<b>\$ 3.37</b>	<b>\$ 3.64</b>

**Underwriting Ratios:**

Loss ratio (1) (4)

Accident year	63%	44%	61%	N/A	56%
Prior years	-49%	-18%	-37%	N/A	-21%
Calendar year	14%	26%	24%	N/A	35%
Expense ratio (2) (4)	18%	16%	17%	N/A	16%
Combined ratio (3) (4)	32%	42%	41%	N/A	51%

(1) Loss ratio is defined as the ratio of losses and loss adjustment expenses to net premiums and maintenance fees earned.

(2) Expense ratio is defined as the ratio of other underwriting expenses and net change in deferred acquisition costs to net premiums and maintenance fees earned.

(3) Combined ratio is the sum of the loss ratio and the expense ratio.

(4) Ratios for the nine month Actual 2007 period are not applicable since the acquisition of API occurred on April 1, 2007.

The discussion that follows should be read in connection with the unaudited Condensed Consolidated Financial Statements and Notes thereto included elsewhere in this report. For additional information regarding the pro forma results of operations of the Company and API had the transaction occurred on January 1, 2007, respectively, please see Note 4 to the Unaudited Condensed Consolidated Financial Statements.

**Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007**

Revenues decreased \$2,993,000 (13%) to \$19,886,000 from \$22,879,000 for the three months ended September 30, 2008 compared to the same three month period for 2007. Our income from operations increased \$2,259,000 (25%) to \$11,181,000 from \$8,922,000 for current year three month period compared to 2007. Our net income increased \$1,891,000 (36%) to \$7,183,000 from \$5,292,000 for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. Our diluted net income per share increased \$0.26 (36%) to \$0.99 from \$0.73 for the three months ended September 30, 2008 as compared to the same three month period in 2007.

The explanations for these changes are described below.

**Gross Premiums and Maintenance Fees Written**

Gross premiums and maintenance fees written decreased \$993,000 (4%) to \$21,246,000 from \$22,239,000 for the three months ended September 30, 2008 as compared to the same period in 2007. The decrease in gross premiums and maintenance fees written was the result of price declines due to soft market conditions. Average rate decreases during the current quarter were 3.7%. Offsetting these decreases were increased premium writings in Oklahoma and Arkansas and better than anticipated policy retention. We increased the number of policyholders to 5,218 at September 30, 2008 from 4,967 at September 30, 2007.

**Premiums Ceded**

Premiums ceded decreased \$207,000 to \$711,000 from \$504,000 for the three months ended September 30, 2008 as compared to the same period in 2007. The reinsurance contracts beginning in 2002 through 2008 are variable premium treaties that have various minimum and maximum rates. The actual premium rate will depend upon the ultimate losses ceded to the reinsurer under the related treaty. We, supported periodically by outside consulting actuarial reviews, continually monitor the development of claims subject to reinsurance and adjust premiums ceded for estimated profit sharing provisions based on claims development in the reinsurance layers.

The effect of reinsurance on premiums earned for the three months ended September 30, are as follows (in thousands):

	<b>Three Months</b>	
	<b>Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
Premiums and maintenance fees earned	\$ 14,998	\$ 17,127
Ceded premiums:		
Current year	(1,320)	(1,931)
Prior years	2,031	2,435
Total ceded premiums	711	504
Net premium and maintenance fees earned	\$ 15,709	\$ 17,631

The decrease in premiums ceded of \$207,000 was primarily the result of recognizing \$2,031,000 of favorable prior reinsurance development for prior years reinsurance treaties during the quarter ended September 30, 2008 as compared to recognizing \$2,435,000 of favorable development during the quarter ended September 30, 2007. Excluding the favorable development for prior years treaties for both periods, ceded premiums would have decreased \$611,000 for the year over year quarters primarily due to the Company retaining 40% of any claim in excess of \$250,000 on individual claims and \$350,000 on multiple insured claims for the 2008 reinsurance treaty. We retained 20% of any excess on the 2007 treaty. We are retaining this additional risk in the reinsurance layer in order to lower our ceding costs based on decreases in claims and coverage limits since the passage of tort reform legislation in Texas in 2003. Also for the second quarter of 2008, ceded premiums for the current treaty year decreased as a result of lower earned premiums and continued improvements in the treaty terms as compared to 2007.

#### **Net Premiums and Maintenance Fees Earned**

Net premiums and maintenance fees earned decreased by \$1,922,000 (11%) to \$15,709,000 from \$17,631,000 for the three months ended September 30, 2008 as compared to the same period in 2007. Written premiums and maintenance fees decreased for the current quarter as compared to the prior year quarter and the aforementioned favorable development recognized at September 30, 2007 for prior years reinsurance treaties contributed to the decrease in net earned amounts.

#### **Investment Income**

Investment income, net of investment expenses, increased by \$92,000 (3%) to \$2,996,000 from \$2,904,000 for the three months ended September 30, 2008 as compared to the same period for 2007. Cash and invested assets increased by \$8,457,000 to \$229,486,000 at September 30, 2008 from \$221,029,000 at September 30, 2007 resulting in the increase in investment income. In addition, the increase in invested assets resulted primarily from positive net cash flow from operating activities. Partially offsetting these increases was lower rates earned on investments during the period.

#### **Realized Capital Gains (Loss)**

Realized capital losses decreased \$2,721,000 to \$474,000 from \$3,195,000 for the three months ended September 30, 2008 as compared to the same period in 2007 primarily as a result of other than temporary impairment losses incurred during the current quarter on Alt-A collateralized mortgage-backed securities being of a lesser amount than those seen in 2007.

Of our entire invested assets, including unrestricted cash as of September 30, 2008, agency-backed mortgage obligations, with underlying collateral consisting of GNMA, FHLMC, or FNMA loans comprise 37% of our portfolio; non-agency collateralized mortgage obligations ( CMO s ) comprise 12% of our portfolio; 12% is comprised of U.S. Treasury notes and bills; 26% is comprised of government agency bonds and notes, municipal tax exempt bonds and corporate bonds and the remaining 13% is cash, equities and other invested assets. The majority of the non-agency CMO s in our portfolio have underlying mortgages categorized as Prime quality loans, and none of our CMO s have underlying mortgages classified as Subprime. As of September 30, 2008 our portfolio contained seven CMO securities with collateral classified as Alternative-A or Alt-A. Alt-A securities are generally considered to have underlying mortgages with underwriting characteristics that are stronger than Subprime mortgages but less stringent than Prime mortgages. All of our Alt-A securities have underlying mortgages with fixed interest rates. All but one of our Alt-A securities are investment grade, currently rated either AA or A. During 2008, one of the Alt-A securities with a book value of \$44,000 was downgraded to a B rating.

Beginning with the three months ended September 30, 2007, we saw a significant and rapid decline in the market value of our Alt-A securities. We considered the deepening national housing crisis and its potential effects on the underlying collateral in evaluating this decline and concluded that the decreases in value of lowest rated Alt-A securities and one of our AA rated Alt-A securities should be considered to be other than temporary as defined in Statements of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The amount of the pretax charge to earnings associated with these adjustments for the three months ended September 30, 2008 was \$830,000. The pretax charge for the comparable quarter ended September 30, 2007 was \$3,140,000. The aggregate write-down on the Alt-A securities since the quarter ended September 30, 2007 is \$9,164,000. While we have the ability to hold all of our Alt-A securities indefinitely, we continue to closely monitor and evaluate these securities and their underlying collateral. We will continue to consider opportunities to reduce our position in Alt-A securities if we determine that it prudently reduces our exposure to further declines that may be considered other than temporary.

The following table reflects the composition of our Alt-A securities as of September 30, 2008 after the other than temporary impairment (dollars in thousands):

Rating Category	"Book" Value	Fair Value	% of Portfolio (Fair Value)
AA	\$ 2,690	\$ 1,686	0.7%
A	1,477	1,552	0.7%
B	44	44	0.0%
Total	\$ 4,211	\$ 3,282	1.4%

During the three months ended September 30, 2008, we evaluated our equity portfolio for other than temporary impairments of certain securities. We based our review primarily on continued stock price declines of certain securities and the length of time we have held the stocks. For the three months ended September 30, 2008, the write-down of equity securities resulted in a realized loss of \$387,000. The fair value of these stocks at September 30, 2008 was \$265,000.

In 2003, we acquired 385,000 shares of common stock of Financial Industries Corporation ( FIC ). The total purchase price was approximately \$5,647,000. Our policy in regards to our investment in FIC had been that we would record pretax charges to earnings should the common stock price on the last day of each interim or annual period fall below the adjusted cost basis of our investment in FIC. From 2004 through 2007, we wrote down the carrying value of the FIC stock by \$3,414,000. On January 15, 2008, FIC announced that it had entered into an agreement and plan of merger pursuant to which it would be acquired. On July 17, 2008 that transaction closed. The basis in our investment in FIC common stock at the closing of the merger was \$5.80 per share and based on the sale price of \$7.25 per share, we recognized a \$558,000 gain in the third quarter of 2008.





**Financial Services Revenues**

Our Financial Services revenue decreased \$3,876,000 (71%) to \$1,558,000 from \$5,434,000 for the three month period ended September 30 2008 compared to the same period in 2007. APS Financial, our broker/dealer, derives most of its revenue from transactions in the fixed income market, in both investment and non-investment grade securities. Commission revenue at APS Financial was down \$2,672,000 (68%) to \$1,279,000 from \$3,952,000 for the three month period ended September 30, 2008 compared to the same period in 2007 due to a continuing trend of very low transaction activity seen throughout the year. Among the factors affecting transaction activity include the well-publicized issues in the mortgage lending and financial markets with the anticipation of the continuation of these factors. The result is the inclination of many of our investors to remain inactive. The same general market conditions affected the combined revenues derived from our investment banking and the bank debt/trade claims business. Decreases in bank debt/trade claim and investment banking revenues combined to total \$1,225,000 (88%) to \$160,000 from \$1,385,000 for the three month period ended September 30 2008 compared to the same period in 2007 due again to difficult credit market conditions. While our Financial Services business constitutes a much less significant portion of our consolidated results of operation since the acquisition of API, we are actively exploring avenues to return this segment to profitability. Cost cutting measures have been implemented which included reduction of personnel, compensation reductions and redundant information services. However, a return to profitability for this segment will also depend, to a large extent, on improved market conditions and a corresponding increase in revenues. We cannot predict when this could occur.

**Loss and Loss Adjustment Expenses**

Loss and loss adjustment expenses decreased by \$2,365,000 (51%) to \$2,259,000 from \$4,624,000 for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The decrease is the result of lower accident year loss and loss adjustment expense and higher favorable development on prior year losses in 2008 as compared to 2007. For the three months ended September 30, 2008, current accident year loss and loss adjustment expenses totaled \$9,949,000 and prior year losses developed favorably by \$7,690,000 as a result of reductions in our estimates of claims severity, principally the 2003 through 2007 report years. For the three months ended September 30, 2007, current accident year loss and loss adjustment expenses were \$7,789,000 and there was \$3,165,000 of favorable development on prior years. The positive effects of tort reform in Texas have resulted in continued favorable development of reserves and improved claim development patterns. We have favorably settled a number of post-tort reform claims from the 2004 and 2005 report years at below the reserved amounts. We continue to accrue our current accident year losses conservatively based on increases in policyholder count from 4,967 as of September 30, 2007 to 5,218 as of September 30, 2008. We also continue to use a conservative approach in our reserving methodology, in all periods including the current accident year.

**Other Underwriting Expenses and Net Change in Deferred Acquisition Costs**

Other underwriting expenses decreased by \$42,000 (1%) to \$3,220,000 from \$3,262,000 for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. Other underwriting expenses consist primarily of commissions to agents, premium taxes, consulting actuary fees and other general underwriting expenses related to our Insurance Services segment. The decrease of \$42,000 for 2008 is mainly attributable to decreased commissions and premium taxes based on lower written premiums for the three months ended September 30, 2008 as compared to the same period in 2007. The net change in deferred acquisition costs, which is comprised of the change in deferred and amortized commissions paid to agents on new and renewal business and deferred and amortized premium taxes, increased for the three months ended September 30, 2008 by \$41,000 to \$(403,000) from \$(444,000) for the comparable period in 2007 due to new costs capitalized exceeding the amortization of prior deferred expenses.

**Management Service Expenses**

Prior to the acquisition of API, the historical results of operations of our Insurance Services segment were determined by the management fees we received from API pursuant to a management agreement and the expenses incurred in managing API's operations. In conjunction with the merger with API on April 1, 2007, our management agreement was terminated as of March 31, 2007 and as such is no longer included in our consolidated results of operations. Therefore, there are no insurance management services expenses for the three months ended September 30, 2008 and 2007. Insurance management services expenses were recorded only through the three months ended March 31, 2007.

**Financial Services Expenses**

Our Financial Services expenses decreased \$2,780,000 (57%) to \$2,127,000 from \$4,907,000 for the three months ended September 30, 2008 as compared to the same period in 2007. The primary reason for the decrease is a reduction of commission expenses of \$2,305,000 (75%) to \$785,000 from \$3,090,000 for the three months ended June 30, 2008 compared to the same period in 2007 due to the decline in trading activity and associated commission revenues mentioned above. Legal and professional expenses decreased \$230,000 (58%) to \$165,000 from \$395,000 for the three months ended September 30, 2008 compared to the same period in 2007 due primarily to costs incurred during the third quarter of 2007 associated with becoming compliant with the Sarbanes-Oxley Act ("SOX"). Consulting fees for SOX compliance in our second year have been significantly reduced. Lastly, incentive compensation costs decreased \$160,000 (68%) to \$75,000 from \$235,000 for the three months ended September 30, 2008 as compared to the same period in 2007 as a result of the net loss incurred thus far in 2008 for this operating segment.

**General and Administrative Expenses**

General and administrative expenses decreased \$106,000 (7%) to \$1,502,000 from \$1,608,000 for the three months ended September 30, 2008 compared to the same period in 2007. The decrease in general and administrative expenses in the current quarter is primarily the result of lower interest expense on our mandatorily redeemable preferred stock as well as lower professional fees. Professional fees decreased \$113,000 (73%) to \$42,000 from \$155,000 due primarily to lower SOX fees in 2008, benefiting from cost savings that are traditional for a company in its second year of compliance.

**Impairment of Goodwill**

Goodwill was recognized when we repurchased an interest in APS Insurance Services from a minority holder in 2003. Goodwill was determined to exist based on earnings expected to be generated from the management agreement with API. With our purchase of API and termination of the management agreement, we determined that the original circumstances creating the goodwill no longer exist and that the entire \$1,247,000 balance is impaired and was written down in the quarter ended June 30, 2007.

**Minority Interest**

The 3% minority interest in Asset Management, a subsidiary within our Financial Services segment, owned by key individuals within Asset Management, was repurchased by APS Investment Services in the third quarter of 2007 for a nominal amount.

**Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007**

Revenues and all of the other income statement items for the nine months ended September 30, 2007 do not include the operations of API for the first three months of 2007, which we acquired on April 1, 2007. We have included below in the pro forma sections a comparison of our operations had the acquisition occurred on January 1, 2007.

Actual revenues decreased \$4,277,000 (7%) to \$57,341,000 from \$61,618,000 for the nine months ended September 30, 2008 compared to the same nine month period for 2007. Our income from operations increased \$1,690,000 (7%) to \$25,644,000 from \$23,954,000 for the current year nine month period compared to 2007. Our net income decreased \$559,000 (3%) to \$16,709,000 from \$17,268,000 for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. Lastly, our diluted net income per share decreased \$1.08 (32%) to \$2.29 from \$3.37 for the nine months ended September 30, 2008 compared to the same period in 2007.

### **Pro forma**

Pro forma revenues decreased \$18,550,000 (24%) to \$57,341,000 from \$75,891,000 for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. Our income from operations decreased \$3,102,000 (11%) to \$25,644,000 from \$28,746,000 for the current nine month period in 2008 compared to the same period for 2007. Our net income decreased \$1,895,000 (10%) to \$16,709,000 from \$18,604,000 for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. Diluted net income per share was \$2.29 and \$3.64 for the nine months ended September 30, 2008 and 2007, respectively.

The explanations for these changes are described below.

### **Gross Premiums and Maintenance Fees Written**

Gross premiums and maintenance fees written increased to \$51,106,000 from \$37,284,000 for the nine months ended September 30, 2008 as compared to the nine month period ended September 30, 2007. The nine months of 2007 only include the operations of API from April 1, 2007, the date of acquisition.

### **Pro forma**

On a pro forma basis, gross premiums and maintenance fees written decreased \$1,644,000 (3%) to \$51,106,000 from \$52,750,000 for the nine month period ended September 30, 2008 as compared to the same period in 2007. The decrease in gross premiums and maintenance fees written was primarily the result of rate decreases due to soft market conditions. Offsetting these decreases, we increased the number of policyholders to 5,218 at September 30, 2008 from 4,967 at September 30, 2007. In addition, we increased our premium writings in Arkansas and also in Oklahoma where we were admitted to write business in the latter part of 2007.

**Premiums Ceded**

Premiums ceded decreased to \$1,087,000 from \$3,922,000 for the nine months ended September 30, 2008 as compared to the nine months ended June 30, 2007. The nine months of 2007 only include the operations of API from April 1, 2007, the date of acquisition.

**Pro forma**

On a pro forma basis, premiums ceded increased \$428,000 to \$1,087,000 from \$1,515,000 for the nine months ended September 30, 2008 as compared to the same period in 2007. The reinsurance contracts beginning in 2002 through 2008 are variable premium treaties that have various minimum and maximum rates. The actual premium rate will depend upon the ultimate losses ceded to the reinsurer under the related treaty.

The effect of reinsurance on premiums earned for the nine months ended September 30, are as follows (in thousands):

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>Actual</b>	<b>Pro forma</b>
Premiums and maintenance fees earned	\$ 46,570	\$ 52,873
Ceded premiums:		
Current year	(3,945)	(6,556)
Prior years	5,032	8,071
Total ceded premiums	1,087	1,515
Net premium and maintenance fees earned	\$ 47,657	\$ 54,388

The pro forma increase in premiums ceded of \$428,000 is primarily the result of lower prior period development of the swing rated treaties in 2008 as compared to 2007. This prior year favorable development in the reinsurance layer resulted in us recognizing \$5,032,000 as a reduction to ceded premiums for the nine months ended September 30, 2008 as compared to \$8,071,000 of prior year favorable development for the nine months ended September 30, 2007. Additionally, ceded premiums decreased year over year due to the Company retaining 40% of any claim in excess of \$250,000 on individual claims and \$350,000 on multiple insured claims for the 2008 reinsurance treaty. We retained 20% of any excess on the 2007 treaty. We are retaining this additional risk in the reinsurance layer based on decreases in claims and coverage limits since the passage of tort reform legislation in Texas in 2003. In addition, ceded premiums are lower for the current period due to lower earned premiums for the first nine months of 2008 as compared to 2007.

#### **Net Premiums and Maintenance Fees Earned**

Net premiums and maintenance fees earned increased to \$47,657,000 from \$38,077,000 the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. The nine months of 2007 only include the operations of API from April 1, 2007, the date of acquisition.

#### **Pro forma**

On a pro forma basis, net premiums and maintenance fees earned decreased by \$6,731,000 (12%) to \$47,657,000 from \$54,388,000 for the nine months ended September 30, 2008 as compared to the same period in 2007. This decrease is due to average rate decreases of approximately 5.5% during the current year and lower favorable development for the 2002 through 2007 reinsurance swing rated treaties for the nine months ended in 2008 as compared to 2007. Favorable development was \$5,032,000 for the nine months ended September 30, 2008 as compared to \$8,071,000 for the comparable period in 2007. Offsetting the rate decreases was an increase in new business generated from an increase in the number of insureds from 4,967 as of September 30, 2007 to 5,218 as of September 30, 2008.

**Investment Income**

Investment income, net of investment expenses increased \$3,268,000 (57%) to \$9,011,000 from \$5,743,000 for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007 as a result of a substantial increase in invested assets resulting from the acquisition of API on April 1, 2007 and from the proceeds received from our common stock offering in June 2007. The nine months of 2007 only includes the operations of API from April 1, 2007, the date of acquisition.



**Pro forma**

On a pro forma basis, investment income, net of investment expenses, increased by \$1,502,000 (20%) to \$9,011,000 from \$7,509,000 for the nine months ended September 30, 2008 as compared to the same period for 2007. On a pro forma basis, cash and invested assets increased by \$8,457,000 to \$229,486,000 at September 30, 2008 from \$221,029,000 at September 30, 2007 resulting in the increase in investment income. The increase in invested assets resulted primarily from the use of proceeds of our common stock offering as well as from positive net cash flow from operating activities.

**Realized Capital Gains (Losses)**

Realized capital losses increased \$653,000 (18%) to \$4,312,000 from \$3,659,000 for the nine months ended September 30, 2008 as compared to the same period in 2007. The increase is primarily the a result of other than temporary impairment losses of \$5,069,000 during the first nine months of 2008 on our Alt-A collateralized mortgage-backed securities and equity securities compared to \$3,140,000 of impairment losses on our Alt-A securities during the first nine months of 2007. Offsetting these losses was a \$558,000 realized gain on the sale of the FIC stock during the current quarter resulting from the merger which was previously mentioned in the current quarter discussion above.

**Pro forma**

On a pro forma basis, realized capital losses increased \$779,000 to \$4,312,000 from \$3,533,000 for the nine months ended September 30, 2008 as compared to the same period in 2007. This increase in losses is primarily the result of the other-than-temporary impairment losses on our Alt-A securities and equity securities in 2008 as compared to 2007, as described above.

**Financial Services Revenues**

Our Financial Services revenue decreased \$12,788,000 (73%) to \$4,835,000 from \$17,623,000 for the nine month period ended September 30, 2008 compared to the same period in 2007. Commission revenue at APS Financial was down \$8,895,000 (69%) to \$4,042,000 from \$12,937,000 for the nine month period ended September 30, 2008 compared to the same period in 2007 due to a continuing trend of very low transaction activity seen throughout the year. As was the case with the three month decline in revenues mentioned above, the well-publicized issues in the

mortgage lending and financial markets with the anticipation of the continuation of these factors have contributed to the downturn in trading activity. The result is the inclination of many investors to remain inactive. The same general market conditions affected the combined revenues derived from our investment banking and bank debt/trade claims business. Bank debt/trade claim revenue declined \$2,396,000 (83%) to \$474,000 from \$2,870,000 for the nine month period ended September 30 2008 compared to the same period in 2007 due again to difficult credit market conditions. Investment banking transactions decreased \$1,816,000 (91%) to \$175,000 from \$1,991,000 for the nine month period ended September 30, 2008 compared to the same period in 2007. While our Financial Services business constitutes a much less significant portion of our consolidated results of operation since the acquisition of API, we are actively exploring avenues to return this segment to profitability. Cost cutting measures have been implemented which included reduction of personnel, compensation reductions and redundant information services. However, a return to profitability for this segment will also depend, to a large extent, on improved market conditions and a corresponding increase in revenues. We cannot predict when this could occur.

**Loss and Loss Adjustment Expenses**

Loss and loss adjustment expenses increased to \$11,347,000 from \$7,786,000 for the nine months ended September 30, 2008 compared to the same period for 2007. The nine months of 2007 only include the operations of API from April 1, 2007, the date of acquisition.

**Pro forma**

On a pro forma basis, loss and loss adjustment expenses for the nine months ended September 30, 2008 decreased by \$7,610,000 (40%) to \$11,347,000 from \$18,957,000 for the nine months ended September 30, 2007 compared to the first nine months of 2007. The decrease on a pro forma basis is the result of lower accident year loss and loss adjustment expense and higher favorable development on prior year losses in 2008 as compared to 2007. For the nine months ended September 30, 2008, current accident year loss and loss adjustment expenses totaled \$28,862,000 and prior year losses developed favorably by \$17,515,000 as a result of reductions in our estimates of claims severity, principally the 2003 through 2007 report years. For the nine months ended September 30, 2007, current accident year loss and loss adjustment expenses were \$30,306,000 and there was \$11,556,000 of favorable development on prior years. The positive effects of tort reform in Texas have resulted in continued favorable development of reserves and improved claim development patterns. We have favorably settled a number of post-tort reform claims from the 2004 and 2005 report years at below the reserved amounts. We continue to accrue our current accident year losses conservatively based on increases in policyholder count from 4,967 as of September 30, 2007 to 5,218 as of September 30, 2008. As of September 30, 2008, we also continue to use a conservative approach in our reserving methodology, in all periods including the current accident year.

**Other Underwriting Expenses and Net Change in Deferred Acquisition Costs**

Other underwriting expenses increased to \$8,322,000 from \$5,696,000 for the nine months ended September 30, 2008 compared to the comparable six months of 2007. The six months of 2007 only include the operations of API from April 1, 2007, the date of acquisition.

**Pro forma**

On a pro forma basis, other underwriting expenses decreased by \$604,000 (7%) to \$8,322,000 from \$8,926,000 for the nine months ended September 30, 2008 as compared to the same period in 2007. Other underwriting expenses consist primarily of commissions to agents, premium taxes and other general underwriting expenses related to managing our Insurance Services segment. The pro forma decrease of \$604,000 for 2008 is mainly attributable to higher stock-based compensation expenses and legal and auditing fees incurred during the nine months ended September 30, 2007 as a result of the acquisition of API. In addition, current year commissions and premium taxes are lower due to lower written premiums. On a pro forma basis, the net change in deferred acquisition costs, which is comprised of the change in deferred and amortized commissions paid to agents on new and renewal business and deferred and amortized premium taxes, decreased for the nine months ended September 30, 2008 by \$60,000 to \$(206,000) from \$(146,000) for the comparable period in 2007 due to new costs capitalized exceeding the amortization of prior deferred expenses.

*Management Service Expenses*

Prior to the acquisition of API, the historical results of operations of our Insurance Services segment were determined by the management fees we received from API pursuant to a management agreement and the expenses incurred in managing API's operations. In conjunction with the merger with API on April 1, 2007, our management agreement was terminated as of March 31, 2007 and as such is no longer included in our consolidated results of operations. Thus, as a result of the merger, insurance management services expenses decreased to zero in the nine months ended September 30, 2008 compared to \$3,823,000 during the same period in 2007. Insurance services expenses were recorded only through the quarter ended March 31, 2007. On a pro forma basis, management service expenses were \$0 for both periods as these expenses were eliminated in consolidation.

### **Financial Services Expenses**

Our Financial Services expenses decreased \$7,586,000 (49%) to \$8,013,000 from \$15,599,000 for the nine month period ended September 30, 2008 compared to the same period in 2007. The primary reason for the current year decrease is a reduction of commission expenses of \$7,762,000 (75%) to \$2,551,000 from \$10,313,000 for the nine month period ended September 30, 2008 compared to the same period in 2007 resulting from the decline in trading activity and associated commission revenues mentioned above. In addition, incentive compensation costs decreased \$1,125,000 (94%) in the first nine months of 2008 as a result of the net loss incurred thus far in 2008 in this operating segment. Partially offsetting these decreases was an increase in legal and professional expenses of \$1,169,000 (175%) to \$1,837,000 from \$668,000 for the nine month period ended September 30, 2008 compared to the same period in 2007 due primarily to costs incurred related to legal disputes. Lastly, payroll expense increased \$249,000 (17%) to \$1,736,000 from \$1,486,000 due primarily to certain increases in staff at the investment banking and bank debt/trade claims businesses since the third quarter of 2007.

### **General and Administrative Expenses**

General and administrative expenses increased \$421,000 (11%) to \$4,221,000 from \$3,800,000 for the nine month period ended September 30, 2008 compared to the same period in 2007. Salaries increased \$241,000 (31%) to \$1,023,000 from \$782,000 resulting primarily from our hiring a President and Chief Operating Officer in April, 2007 in addition to adding a new Treasurer position in November of 2007. Options, deferred compensation and board fees increased \$185,000 (25%) to \$932,000 from \$747,000 resulting primarily from deferred compensation awarded to officers, board members and key employees as a result of record earnings in 2007 as well as due to a greater number of directors and increased fees paid to each non-management board member for their service to the Company. Partially offsetting these increases was the fact that interest expense decreased \$97,000 (26%) to \$282,000 from \$379,000 and represents dividends due to our preferred shareholders on our mandatorily redeemable preferred stock issued as a result of our 2007 acquisition of API.

### **Liquidity and Capital Resources**

The primary sources of our liquidity for the nine months ended September 30, 2008, are funds provided by insurance premiums collected, net investment income, recoveries from reinsurers and proceeds from the maturity and sale of invested assets. In addition, we received a federal income tax refund for over-payment of estimated 2007 federal income taxes, the result of estimated payments being calculated on an annualized basis and that amount being higher than was actually earned in 2007. The primary uses of cash are losses from insurance claims, loss adjustment expenses, operating expenses, the acquisition of invested and fixed assets and reinsurance premiums.

Cash Flows. Our total cash and cash equivalents balance at September 30, 2008, was \$16,491,000, a decrease of \$1,900,000 (10%) in the current year as cash provided by operating activities partially offset net cash used in investing and financing activities. Our cash flows provided from operating activities totaled \$22,137,000 for the current year on the strength of net income totaling \$16,709,000 and from net reinsurance reimbursements for prior years swing-rated treaties totaling \$7,045,000. Our Insurance Services segment generated the bulk of the cash received from operating activities, the result of increased premium and maintenance fee receipts and decreased claims payouts. Our cash flows used in investing activities totaled \$17,740,000 in the first nine months of 2008 primarily as a result of purchases of available-for-sale fixed income securities in excess of proceeds from their sale. Cash used in financing activities totaled \$6,297,000 for the nine months ended September 30, 2008 primarily as a result of dividend payments to our common and preferred shareholders, preferred share redemptions and repurchases of our common stock, consistent with our share repurchase program.

Historically, we have maintained a strong working capital position and, as a result, we have been able to satisfy our operational and capital expenditure requirements with cash generated from our operating and investing activities. These same sources of funds have also allowed us to pursue investment and expansion opportunities consistent with our growth plans. Although there can be no assurance our operating activities will provide positive cash flow for the remainder of 2008, we are optimistic that our working capital requirements will be met for the foreseeable future because our current cash position is very strong, with a balance of approximately \$16,491,000 and a large portion of our approximate \$212,995,000 investment portfolio is in short-term, highly liquid bonds and other fixed income securities.

Other Significant Balance Sheet Accounts. Reinsurance recoverables decreased by \$3,246,000 (16%) to \$16,773,000 at September 30, 2008 from \$20,019,000 primarily as a result of the favorable development in the reinsurance layer of \$5,032,000 as discussed in Note 7 to the unaudited financial statements included herein.

In addition to an adjustment to premiums ceded, estimates of ultimate reinsurance ceded premium amounts compared to the amounts paid on a provisional basis give rise to a balance sheet asset classified as *Other Amounts Receivable Under Reinsurance Contracts* or a balance sheet liability classified as *Funds Held Under Reinsurance Treaties*. Furthermore, each retrospective treaty requires a 24 or 36 month holding period before any premium adjustments or cash can be returned or paid. The ultimate settlement amount is not determined until all losses have been settled under the respective treaties. As of September 30, 2008, we have recorded a balance sheet asset, *Other Amounts Receivable Under Reinsurance Contracts* of \$558,000 and a balance sheet liability, *Funds Held Under Reinsurance Treaties* of \$4,363,000, which represent the differences between the estimates of ultimate reinsurance premiums ceded amounts for the 2002 through 2008 treaty years as compared to the amounts paid on a provisional basis.

Other amounts receivable under reinsurance contracts decreased \$3,977,000 (88%) to \$558,000 at September 30, 2008 from \$4,535,000 at December 31, 2007 due to a net payment of \$7,045,000 received from reinsurers primarily for the initial reimbursement for the excess reinsurance premiums paid on a provisional basis for the 2005 treaty year.

Accrued expenses and other liabilities decreased \$2,184,000 (30%) to \$5,003,000 at September 30, 2008 from \$7,187,000 at December 31, 2007 primarily as a result of payment of accrued 2007 incentive compensation in March, 2008 partially offset by 2008 incentive compensation accruals. In addition, there was a decrease of \$1,152,000 in advance premiums and other policyholder liabilities. Partially offsetting these decreases was an increase in accrued legal fees.

Federal income taxes went from a receivable of \$1,957,000 at December 31, 2007 to a payable of \$1,043,000 at September 30, 2008, a change of \$3,000,000. The primary reason for the increase in taxes payable are the federal income taxes on 2008 earnings in addition to a receipt in the current year of a 2007 federal income tax refund of \$1,957,000. Partially offsetting these decreases in the receivable was total estimated federal income tax payments of \$8,300,000.

Capital Expenditures. In April 2007 we entered into a contract with a vendor to provide us with, and assist in the implementation of, an integrated policy and claims administration system. The total cash outflow for the project is anticipated to be approximately \$1,900,000 of which \$1,159,000 has been capitalized to date. Our capital expenditures for equipment were \$728,000 for the nine months ended September 30, 2008 of which approximately \$312,000 were expenditures related to this software implementation project. We expect to incur additional capital expenditures of

approximately \$741,000 for the remainder of this project, which are to be funded from cash on hand over the next twelve months.

Restrictions on Dividends by API. In addition to restrictions on dividends and distributions applicable to all Texas stock insurance companies, for so long as any Series A redeemable preferred stock is outstanding, the Texas Department of Insurance ( TDI ) prohibits API from paying dividends to us in any fiscal year unless and until we have complied with our redemption and dividend payment obligations to the holders of our Series A redeemable preferred stock for that year. We have also agreed that, without prior approval of the TDI, aggregate annual distributions to us in respect of API s capital stock may not exceed the lesser of 10% of API s prior year-end policyholder statutory earned surplus or API s prior year net income, and in no event may exceed API s statutory earned surplus. During the nine months ended September, 2008, API paid approximately \$6,376,000 in dividends to us with TDI approval.

Escrow Account. In connection with the API acquisition, the TDI has required us to place \$2,500,000 into an escrow account with a bank, to remain in escrow until the aggregate remaining redemption and dividend obligation relating to our Series A redeemable preferred stock is less than the amount of the escrow balance. No withdrawals may be made from this escrow account without prior approval from the TDI.



### **Adoption of Recent Accounting Pronouncements**

In September 2006, the FASB issued Statement of Financial Accounting Standards, or SFAS No. 157, *Accounting for Fair Value Measurements*, effective for fiscal years beginning after November 15, 2007. However, on February 12, 2008, the FASB issued FSP FAS 157-2 which would delay the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP partially defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. This Statement defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. Effective January 1, 2008, we have adopted this standard and a more detailed discussion is included in Note 17 to evaluating the impact, if any, the adoption of this standard will have on our financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits entities to choose to measure certain financial assets and liabilities at fair value which are otherwise measured on a different basis in existing literature. Additional disclosures are required. It is effective for the Company, if elected, as of January 1, 2008. We are currently evaluating the impact on our financial position, results of operations or cash flows if we would choose to adopt this standard.

In December 2007, the FASB issued Statement of Financial Accounting Standards, or SFAS, No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt the Statement on its effective date. The adoption is not expected to have a significant effect on our financial position, results of operations or cash flows.

In December 2007, the FASB issued Statement of Financial Accounting Standards, or SFAS No. 141 (Revised December 2007) *Business Combinations* (SFAS 141R). SFAS 141R replaces FASB Statement No. 141, *Business Combinations* but retains the fundamental requirement in SFAS 141 that the acquisition method (referred to as the purchase method in SFAS 141) of accounting be used for all business combinations. SFAS 141R provides new and additional guidance with respect to business combinations including: defining the acquirer in a transaction, the valuation of assets and liabilities when non-controlling interests exist, the treatment of contingent consideration, the treatment of costs incurred to effect the acquisition, the treatment of reorganization costs, and the valuation of assets and liabilities when the purchase price is below the net fair value of assets acquired. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt the Statement on its effective

date.

In April 2008, the FASB issued FSP No. 142-3, Determination of the Useful Life of Intangible Assets. FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. FSP No. 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We are currently evaluating the impact of the pending adoption of FSP No. 142-3 on our consolidated financial statements.

### **Off Balance Sheet Arrangements**

There were no off-balance sheet arrangements as of September 30, 2008.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are principally exposed to three types of market risk related to our investment operations, including credit risk, interest rate risk, and equity price risk. The term market risk refers to the risk of a loss arising from adverse changes in market rates and prices such as interest rates, credit risk, equity prices and foreign currency exchange rates.

We invest our assets primarily in fixed-maturity securities, which as of September 30, 2008 and December 31, 2007 comprised approximately 87% and 86% of total investments, including unrestricted cash balances, at market value. As of September 30, 2008 and December 31, 2007, the fair value of investments in fixed maturity securities was \$200,083,000 and \$191,609,000.

The fixed-income maturities consist predominately of investment grade U.S. government agency and non-agency collateralized mortgage obligations and U.S. government agency mortgage-backed bonds for the purpose of generating ample cash flow to meet claim funding requirements while maintaining a reasonable investment yield.

We have exposure to credit risk primarily as a holder of fixed-income securities. We control this exposure by emphasizing investment grade quality in the fixed-income securities we purchase. At September 30, 2008 and at December 31, 2007, substantially all of our fixed-income portfolio consisted of investment grade securities. We believe that this concentration of investment grade securities limits our exposure to credit risk on our fixed-income investments. For additional discussion of our fixed income securities including our Alt-A securities and related other than temporary impairment, see Note 4 to unaudited financial statements included herein and Item 2. Management's Discussion and Analysis and Results of Operations.

Equity securities comprised approximately 5% of total investments, including unrestricted cash, at market value as of September 30, 2008 and December 31, 2007, respectively. As of September 30, 2008 and December 31, 2007, the fair value of investments in equity securities was \$11,332,000 and \$11,406,000, respectively.

Equity securities are subject to equity price risk, which is defined as the potential for loss in market value due to a decline in equity prices. The value of common stock equity investments is dependent upon the general conditions in the securities markets and the business and financial performance of the individual companies in the portfolio. Values are typically based on future economic prospects as perceived by investors in the equity markets. 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. For additional discussion of our equity securities and related other than temporary impairment, see Note 4 to unaudited financial statements included herein and Item 2. Management's Discussion and Analysis and Results of Operations.

The remainder of the investment portfolio consists of cash and highly liquid short-term investments.

As mentioned above, our invested assets are subject to interest rate risk and equity price risk. The following table presents the effect as of September 30, 2008 on current estimated fair values of the fixed-maturity securities available-for-sale and equity securities assuming a 100-basis point (1%) increase in market interest rates and a 10% decline in equity prices.

		<b>Estimated Fair</b>		<b>Estimated Fair</b>
		<b>Value at</b>		<b>Value at</b>
		<b>Current Market</b>		<b>Adjusted Market</b>
	<b>Carrying Value</b>	<b>Rates/Prices</b>		<b>Rates/Prices (1)</b>
		<b>(in thousands)</b>		
Interest rate risk:				
Fixed-maturities; available for sale	\$ 200,083	\$ 200,083	\$	189,240
Equity price risk:				
Equity securities	\$ 11,332	\$ 11,332	\$	10,199

(1)

Adjusted rates assume a 100 basis point (1%) increase in market rates for fixed rate securities and a 10% decline in equity market values.

For all our financial assets and liabilities, we seek to maintain reasonable average durations, consistent with the maximization of income, without sacrificing investment quality and providing for liquidity and diversification.

The estimated fair values at current market rates for financial instruments subject to interest rate risk and equity price risk in the table above are the same as those included elsewhere herein. The estimated fair values are calculated using simulation modeling based on the most likely outcome, assuming a 100-basis point shift in interest rates.

This sensitivity analysis provides only a limited, point-in-time view of the market risk sensitivity of certain of our financial instruments. The actual impact of market interest rate and price changes on the financial instruments may differ significantly from those shown in the sensitivity analysis. The sensitivity analysis is further limited, as it does not consider any actions that we could take in response to actual and/or anticipated changes in interest rates and equity prices.

We are also subject to credit risk with respect to our reinsurers. Although our reinsurers are liable to us to the extent we cede risk to them, we are ultimately liable to our policyholders on all risks we have reinsured. As a result, reinsurance agreements do not limit our ultimate obligations to pay claims to policyholders and we may not recover

claims made to our reinsurers.

Additionally, our revenues generated through commissions at our Financial Services segment also expose us to market risk. 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, and this move may impact our level of business in different fixed-income sectors. If a generally improving economy is the impetus behind higher rates, then while our investment grade business may drop off, our high yield business might improve with improving credit conditions. A volatile interest rate environment could also impact our business as this type of market condition can lead to investor uncertainty and their corresponding unwillingness to commit funds. When trading volume is generally low, our Financial Services segments' profitability is adversely affected because our overhead remains relatively fixed, despite lower compensation costs associated with commission revenues.

## **ITEM 4. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to ensure material information required to be disclosed in the Company's reports that it files or submits under the Securities Exchange Act of 1934 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 the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure. In designing and evaluating the disclosure controls and procedures, the Company recognized that a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's Disclosure Committee and management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2008.

### **Changes in Internal Control over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II**

### **OTHER INFORMATION**

#### **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. See Note 9 to the Unaudited consolidated financial statements included herein.

#### **ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the period ended December 31, 2007 which could materially affect our business, financial condition or future results. The risks described in this report are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial could have a material adverse effect on our business, financial condition and results of operations.

#### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Items 2(a) and (b) are inapplicable.

(c) Stock Repurchases for the three months ended September 30, 2008:

<b>Period</b>	<b>Total</b>	<b>Average</b>	<b>Total</b>	<b>Maximum</b>
---------------	--------------	----------------	--------------	----------------



	<b>Number of shares Purchased (1)</b>	<b>Price Paid Per Share</b>	<b>Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Dollar Value of Shares that May yet be Purchased under the Plans or Programs (2)</b>
July 1, 2008 – July 31, 2008	12,213	\$ 20.12	12,213	\$ 2,110,000
August 1, 2008 – August 31, 2008	19,604	\$ 20.10	19,604	\$ 1,716,000
September 1, 2008 – September 30, 2008	9,600	\$ 21.38	9,600	\$ 1,510,000

(1)

Of the total shares purchased, 41,413 were purchased in open market transactions and 4 were purchased in private transactions.

(2)

Our original \$2,000,000 share repurchase program was announced August 17, 2004 and was increased in \$2,000,000 increments on December 12, 2005 and on June 30, 2006, \$1,000,000 on September 7, 2007 and \$4,000,000 on March 5, 2008. As of September 30, 2008, we had a maximum dollar value of \$1,510,000 remaining for the future purchase of shares under the Stock Repurchase program. In October 2008, subsequent to the quarter end, the board of directors authorized an additional increase of \$4,000,000 under the share repurchase program.

Our open market stock repurchases are made in reliance upon Rule 10b-18 of the Exchange Act safe harbor from certain market manipulation claims for purchases by an issuer of its own common stock. Under this rule, we may not open trading in our shares, may not trade in the last thirty minutes of the trading session, may bid no more than the current bid or last trade, and may purchase no more in a single day than 25% of the average daily trading volume for the last four calendar weeks, unless certain rules for larger block trades are followed. Our stock option plan allows us to accept shares owned by an optionee immediately prior to the exercise of an option in payment for the option exercise. Additionally, we consider unsolicited offers to sell shares back to us and make a decision on purchasing them based on the price and our business needs at the time of the offer. We give priority in our repurchases to shares offered in option exercises, followed by open market purchases and finally unsolicited offers from shareholders. We do not reissue any shares acquired in repurchases, instead canceling them upon acquisition.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not Applicable

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

There were no matters submitted to vote to security holders during the three months ended September 30, 2008.

### **ITEM 5. OTHER INFORMATION**

Not Applicable

### **ITEM 6. EXHIBITS**

31.1

Section 302 Certification of Chief Executive Officer (1)

31.2

Section 302 Certification of Chief Financial Officer (1)

32.1

Section 906 Certification of Chief Executive Officer (1)

32.2

Section 906 Certification of Chief Financial Officer (1)

---

(1)

Filed herewith.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**American Physicians Service Group,  
Inc.**

Date: November 4, 2008

/s/ Marc J. Zimmermann  
Marc J. Zimmermann, Chief Financial  
Officer

