DYNARESOURCE INC
Form 10-K/A
February 08, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

Amendment No. 1

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2011

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

For the transition period from ________________________ to ________________________

Commission File Number: 000-30371

DYNARESOURCE, INC.

(Exact name of Registrant as specified in its charter)

Delaware	94-1589426
(State of Incorporation)	(Employer Identification No.)

222 W. Las Colinas Blvd., Suite 744 East Tower Irving, Texas	75039
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number: Phone: (972) 868-9066; Fax: (972) 868-9067

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock; $0.01 Par Value

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes [ ]   No [X]

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

Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes [ ] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

Large accredited filer [ ] Accredited filer [ ]

Non-accredited filer [ ] Smaller reporting company [X]

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

Yes [ ]   No [X]

The aggregate market value of common stock, par value $0.01 per share, held by non-affiliates of the registrant, based on the average bid and asked prices of the common stock on June 30, 2011 (the last business day of the registrant's most recently completed second fiscal quarter) was approximately $35.2 million. For purposes of this computation, all officers, directors and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed an admission that such officers, directors or 10% beneficial owners are, in fact, affiliates of the registrant.

Number of common shares outstanding at March 30, 2012   10,602,868

EXPLANATORY NOTE

We are filing this Amendment No. 1 on Form 10-K/A (this "Amendment") to amend our annual report on Form 10-K for the fiscal year ended December 31, 2011, filed with the Securities and Exchange Commission ("SEC") on April 2, 2012 (the "Original Form 10-K"). This Report is being filed for the sole purpose of responding to comments of the staff of the SEC.

As required by Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), new certifications of our principal executive officer and principal financial officer are being filed as exhibits to this Report.

DOCUMENTS INCORPORATED BY REFERENCE

Listed below are documents incorporated herein by reference and the part of this Report into which each such document is incorporated:

None

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Exhibit 31.2	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) of the Exchange Ace, as enacted by Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 United States Code Section 1350, as enacted by Section 906 of the Sarbanes-Oxley Act of 2002

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FORWARD-LOOKING STATEMENTS

This annual report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, which we refer to in this annual report as the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, which we refer to in this annual report as the Exchange Act. Forward-looking statements are not statements of historical fact but rather reflect our current expectations, estimates and predictions about future results and events. These statements may use words such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “predict,” “project” and similar expressions as they relate to us or our management. When we make forward-looking statements, we are basing them on our management’s beliefs and assumptions, using information currently available to us. These forward-looking statements are subject to risks, uncertainties and assumptions, including but not limited to, risks, uncertainties and assumptions discussed in this annual report. Factors that can cause or contribute to these differences include those described under the headings “Risk Factors” and “Management Discussion and Analysis and Plan of Operation.”

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Any forward-looking statement you read in this annual report reflects our current views with respect to future events and is subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or individuals acting on our behalf are expressly qualified in their entirety by this paragraph. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this annual report. The Company expressly disclaims any obligation to release publicly any updates or revisions to these forward-looking statements to reflect any change in its views or expectations. The Company can give no assurances that such forward-looking statements will prove to be correct.

CAUTIONARY NOTE TO UNITED STATES INVESTORS -- INFORMATION CONCERNING PREPARATION OF RESOURCE AND RESERVE ESTIMATES

The Company is required to prepare reports under the Canadian Securities Administrators’ National Instrument 43-101 “Standards of Disclosure for Mineral Projects” (“NI 43-101”), under the Canadian securities laws because we are subject to Canadian securities laws. These standards are materially different from the standards generally permitted in reports filed with the United States Securities and Exchange Commission (“SEC”).

The terms “mineral reserve”, “proven mineral reserve” and “probable mineral reserve” used in this report are Canadian mining terms defined in accordance with the Canadian Institute of Mining, Metallurgy and Petroleum (the “CIM”) in the CIM Standards on Mineral Resources and Mineral Reserves, adopted by the CIM Council. These definitions differ from the definitions of those terms in Industry Guide 7 (“Guide 7”) promulgated by the SEC. Under U.S. standards, mineralization may not be classified as a “reserve” unless a determination has been made that the mineralization could be economically and legally produced or extracted at the time the reserve determination is made. Under Guide 7 standards, a “Final” or “Bankable” feasibility study is required to report reserves, the three-year historical average precious metals prices are used in any reserve or cash flow analysis to designate reserves, and the primary environmental analysis or report must be filed with the appropriate government authority. One consequence of these differences is that “reserves” calculated in accordance with Canadian standards may not be “reserves” under Guide 7 standards. U.S.

investors should be aware that the Company's properties located in Mexico do not have "reserves" as defined by Guide 7 and are cautioned not to assume that any part or all of the disclosed mineralized material will be confirmed or converted into Guide 7 compliant "reserves".

Under NI 43-101, we report measured, indicated and inferred resources, which are measurements that are generally not permitted in filings made with the SEC. The estimation of measured resources and indicated resources involve greater uncertainty as to their existence and economic feasibility than the estimation of proven and probable reserves. U.S. investors are cautioned not to assume that any part of measured or indicated resources will ever be converted into economically mineable reserves. The estimation of inferred resources involves far greater uncertainty as to their existence and economic viability than the estimation of other categories of resources. It cannot be assumed that all or any part of inferred resources will ever be upgraded to a higher category. Therefore, U.S. investors are also cautioned not to assume that all or any part of inferred resources exist, or that they can be mined legally or economically.

PART I

Item 1. Business

Company.

DynaResource, Inc., the Company described herein, is a Delaware corporation, with offices located at 222 W. Las Colinas Blvd., Suite 744 East Tower, Irving, Texas 75039. It can be reached by phone at (972) 868-9066 and by fax at (972) 868-9067.

History.

The Company was incorporated in the State of California on September 28, 1937, under the name West Coast Mines, Inc. In November 1998, the Company re-domiciled from California to Delaware and changed its name to DynaResource, Inc.

The Company is in the business of acquiring, investing in, and developing precious metal properties, and the production of precious metals.

Through its 50% owned Mexican subsidiary, DynaResource de México, S.A. de C.V. ("DynaMéxico"), the Company owns a portfolio of mining concessions that currently includes its interests in the San José de Gracia (SJG) Project in Sinaloa State, in northern Mexico. The SJG District covers 69,121 hectares (170,802 acres) on the west side of the Sierra Madre Mountains.

DynaResource owns a 50% common stock interest in DynaMéxico, and the remaining 50% common stock interest is held by Goldgroup Mining Inc.

A wholly owned subsidiary of the Company, Mineras de DynaResource S.A. de C.V. ("MinerasDyna"), entered into an operating agreement with DynaMéxico on April 15, 2005 and, as a consequence of that agreement, is the named exclusive operating entity for the SJG Project.

In 2005, the Company formed another wholly owned subsidiary, DynaResource Operaciones, SA de C.V. ("DynaOperaciones"). DynaOperaciones entered into a personnel management agreement with MinerasDyna and, as a consequence of that agreement, is the exclusive manager of personnel for the SJG Project.

Licenses and Concessions

The SJG District is comprised of 33 mining concessions covering 69,121 hectares (171,802 acres) and is located within the Sierra Madre gold-silver belt, where the majority of hydrothermal deposits in Mexico are located. The Company's concessions, all of which are formally held by DynaMéxico, are granted by the Mexican government, or acquired from previous owners. The Company's concessions are comprised of a combination of exploration concessions and development concessions, are filed in the Public Registry of Mining, and are scheduled to expire from 2028 through 2058. The concessions can be renewed prior to the expiry dates. The table below contains a listing of the mineral concessions currently held by DynaMéxico.

DynaMexico plans to apply for certain operating licenses and additional permits as part of its pre-production activities for the San Jose de Gracia property. The licenses and permits would be issued by the host government, whether state or federal.

Current Mining Concessions - San José de Gracia

Claim Name	Claim Number	Staking date	Expiry	Hectares	Taxes / ha (pesos)
AMPL. SAN NICOLAS	183815	22/11/1988	21/11/2038	17.4234	111.27
AMPL. SANTA ROSA	163592	30/10/1978	29/10/2028	25.0000	111.27
BUENA VISTA	211087	31/03/2000	30/03/2050	17.9829	63.22
EL CASTILLO	214519	02/10/2001	01/10/2051	100.0000	31.62
EL REAL	212571	07/11/2000	06/11/2050	2037.9479	63.22
EL REAL 2	216301	30/04/2002	29/04/2052	280.1555	31.62
FINISTERRE FRACC. A	219001	28/01/2003	27/01/2053	18.7856	31.62
FINISTERRE FRACC. B	219002	28/01/2003	27/01/2053	174.2004	31.62

Claim Name	Claim Number	Staking date	Expiry	Hectares	Taxes / ha (pesos)
GUADALUPE	189470	05/12/1990	04/12/2040	7.0000	111.27
LA GRACIA I	215958	02/04/2002	01/04/2052	300.0000	31.62
LA GRACIA II	215959	02/04/2002	01/04/2052	230.0000	31.62
LA LIBERTAD	172433	15/12/1983	14/12/2033	97.0000	111.27
LA NUEVA AURORA	215119	08/02/2002	07/02/2052	89.3021	31.62
LA NUEVA ESPERANZA	226289	06/12/2005	05/12/2055	40.0000	7.6
LA UNION	176214	26/08/1985	25/08/2035	4.1098	111.27
LOS TRES AMIGOS	172216	27/10/1983	26/10/2033	23.0000	111.27
MINA GRANDE	163578	10/10/1978	09/10/2028	6.6588	111.27
NUEVO ROSARIO	184999	13/12/1989	12/12/2039	32.8781	111.27
PIEDRAS DE LUMBRE 2	215556	05/03/2002	04/03/2052	34.8493	31.62
PIEDRAS DE LUMBRE 3	218992	28/01/2003	27/01/2053	4.3098	31.62
PIEDRAS DE LUMBRE No.4	212349	29/09/2000	28/09/2050	0.2034	63.22
PIEDRAS DE LUMBRE UNO	215555	05/03/2002	04/03/2052	40.2754	31.62
SAN ANDRES	212143	31/08/2000	30/08/2050	385.0990	63.22
SAN JOSÉ	208537	24/11/1998	23/11/2048	27.0000	111.27
SAN MIGUEL	183504	26/10/1988	25/10/2038	7.0000	111.27
SAN NICOLAS	163913	14/12/1978	13/12/2028	55.5490	111.27
SAN SEBASTIAN	184473	08/11/1989	07/11/2039	40.0000	111.27
SANTA MARIA	218769	17/01/2003	16/01/2053	4.2030	31.62
SANTA ROSA	170557	13/05/1982	12/05/2032	31.4887	111.27
SANTO TOMAS	187348	13/08/1986	12/08/2036	312.0000	111.27
TRES AMIGOS 2	212142	31/08/2000	30/08/2050	54.4672	63.22
FINISTERRE 4	231166	18/01/2008	17/01/2058	2142.1302	5.08
FRANCISCO ARTURO	230494	06/09/2007	27/03/2057	62481.3815	5.08
TOTAL				**69,121.4010**	

The San Jose de Gracia mining property surrounds the area of San Jose de Gracia, Sinaloa State, Mexico. San Jose de Gracia is located on the west side of the Sierra Madre Mountains in the Sierra Madre Gold-Silver Belt, approximately 100 kilometers inland from Los Mochis, Sinaloa Mexico and approximately 200 kilometers north of Mazatlan, Sinaloa. (See Map below). The SJG property is described in more detail in this Form 10-K, under Item 2, Properties.

Sierra Madre Gold-Silver Belt in Mexico

Historical Production

SJG reports 1,000,000 Oz. gold historical production from a series of underground workings. 471,000 Oz. Au is reported produced at the La Purisima area of SJG, at an average grade of 66.7 g/t; and 215,000 Oz. Au is reported produced from the La Prieta area, at an average grade of 27.6 g/t. Mineralization at SJG has been traced on surface and underground over a 15 square kilometer area.

1997-1998 Drilling – Exploration Programs

A drill program was conducted at SJG in 1997 - 1998 by a prior majority owner. Approximately 6,172 meters drilling was completed in 63 core drill holes. Significant intercepts, including bonanza grades, outlined the down dip potential of the Northeast section (150 Meter NE to SW extent of the Drilling) of the Los Hilos to Tres Amigos Trend of SJG. Surface and underground sampling in 1999 - 2000 confirmed high grades in historic workings and surface exposures throughout the project area. These high grades outline the presence of mineralization shoots developed within the veins. The mineralization shoots appear to be controlled by dilational jogs and/or vein intersections. A total of 544 samples were collected in 1999-2000, and assayed an average 6.51 grams/ton gold.

Pilot Production Activities

DynaMexico, conducting activities through its operating sister companies MinerasDyna and DynaOperaciones, mined high-grade veins at the San Pablo area of income: Net loss -- -- (578) $(578) -- -- (578) Other comprehensive loss Unrealized loss on securities, net of tax of $2 -- -- -- (7) (7) -- (7) Comprehensive loss -- -- -- $(585) -- -- -- ------ ---------- ---------- ---------- --------------- ------------ ----------- ------------- ---------- ---------- ---------- --------------- ------------ ----------- ------------- Balance December 31, 2001 $275 $5,539 $8,310 $(39) $(1,418) $12,667 ---------- ---------- ---------- --------------- ------------ ----------- ------------- ---------- ---------- ---------- --------------- ------------ ----------- ------------- Comprehensive income: Net income $ -- $ -- $3,411 $3,411 $ -- $ -- $3,411 Other comprehensive income: Unrealized gain on securities, -- -- -- 1,869 1,869 -- 1,869 net of tax of $963 ------ Comprehensive income -- -- -- $5,280 -- -- -- ------ Stock Options Exercised 1 45 -- -- -- 45 Treasury stock purchases -- -- -- -- (850) (850) Retired Treasury Stock (62) -- (2,206) -- 2,268 -- ---------- ---------- ---------- --------------- ------------ ----------- ------------ ---------- ---------- ---------- --------------- ------------ ----------- ------------ Balance December 31, 2002 $ 213 $ 5,584 $ 9,515 $ 1,830 -- $ 17,142 ========== ========== ========== =============== ============ =========== ============ See accompanying notes to consolidated financial statements. A-10 AMERICAN PHYSICIANS SERVICE GROUP, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2002 and 2001 (1) Summary of Significant Accounting Policies (a) General We, through our subsidiaries, provide financial services that include brokerage and asset management services to individuals and institutions, insurance services that consist of management services for a malpractice insurance company, and until November 1, 2002, provided environmental consulting services that included air, water and solid waste engineering, litigation support and regulatory compliance. The financial services business has clients nationally. Insurance management is a service provided primarily in Texas, but is available to clients nationally.

During the two years presented in the financial statements, financial services generated 52% and 57% of total revenues and insurance services generated 36% and 32% in 2002 and 2001, respectively. We have an affiliate, Uncommon Care, Inc. ("Uncommon Care") of which we own common stock and convertible preferred stock equivalent to a 42% ownership on a fully converted basis. Uncommon care is a developer and operator of Alzheimers care centers. (b) Management's Estimates and Assumptions The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. (c) Principles of Consolidation The consolidated financial statements include our accounts and the accounts of our subsidiary companies more than 50% owned. Investments in affiliated companies and other entities, in which our investment is less than 50% of the common shares outstanding and where we exert significant influence over operating and financial policies, are accounted for using the equity method. Investments in other entities in which our investment is less than 20%, and in which we do not have the ability to exercise significant influence over operating and financial policies, are accounted for using the cost method. We also consolidate our interest in APS Consulting ("APS Consulting") as it is accounted for as a variable interest entity in which we are the primary beneficiary. (See Note 13). We own 80% of our insurance services segment. We record minority interest to reflect the 20% of it's net income or loss attributable to the minority shareholder. All significant inter-company transactions and balances have been eliminated from the accompanying consolidated financial statements. (d) Revenue Recognition Our investment services revenues related to securities transactions are recognized on a trade date basis. Asset management revenues are recognized monthly based on the amount of funds under management. A-11 Our insurance services revenues related to management fees are recognized monthly as a percentage of the earned insurance premiums of the managed company. The profit sharing component of the management services agreement is recognized when it is reasonably certain that the managed company will have an annual profit, generally in the fourth quarter of each year. Our consulting revenues resulted from the work of scientists and engineers in the areas of remedial investigations, remediation engineering, air and water quality analysis, regulatory compliance, solid waste engineering, litigation support/expert testimony and industrial hygiene and safety. Substantially all of the projects in these areas are undertaken on a time and expenses basis. Our clients were billed, and revenue was recognized, monthly based on hours worked and expenses incurred toward completing the assignments. Effective November 1, 2002, we completed the sale of our consulting segment to its management as it was determined that it did not fit in our long-term business plan (see Note 14 for description of the accounting treatment of this transaction.) (e) Marketable Securities Our investments in debt and equity securities are classified in three categories and accounted for as follows: Classification Accounting -------------- ------------- Held-to-maturity Amortized cost Trading securities Fair value, unrealized gains and losses included in earnings Available-for-sale Fair value, unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of applicable income taxes We have included our marketable securities, held as inventory at our broker/dealer, in the trading securities category. We have included investments in marketable securities not held as inventory at our broker/dealer in the available-for-sale securities category. (f) Property and Equipment Property and equipment is stated at cost. Property and equipment is depreciated using the straight-line method over the estimated useful lives of the respective assets (3 to 5 years). Leasehold improvements are depreciated using the straight-line method over the life of the lease. (g) Long-Lived Assets Long-lived assets, principally property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, a loss is recognized if there is a difference between the fair value and carrying value of the asset. A-12 Investments are evaluated for impairment in the event of a material change in the underlying business. Such evaluation takes into consideration our intent and time frame to hold or to dispose of the investment and takes into consideration available information, including recent transactions in the stock, expected changes in the operations or cash flows of the investee, or a combination of these and other factors. (h) Allowance for Doubtful Accounts We recorded an allowance for doubtful accounts based on specifically identified amounts that we believe to be uncollectible. If our actual collections experience changes, revisions to our allowance may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customer's credit could have a material affect on our results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. (i) Income Taxes Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not. (j) Cash and Cash Equivalents Cash and cash equivalents include cash and highly liquid investments with a maturity date at purchase of 90 days or less. We deposit our cash and cash equivalents with high credit quality institutions. Periodically such balances may exceed applicable FDIC insurance limits. Management has assessed the financial condition of these institutions and believes the possibility of credit loss is minimal. (k) Notes Receivable Notes receivable are recorded at cost, less allowances for doubtful accounts when deemed necessary. Management, considering current information and events regarding the borrowers ability to repay their obligations, considers a note to be impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the note agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the note's effective interest rate. Impairment losses are included in the allowance for doubtful accounts through a charge to bad debt expense. The present value of the impaired loan will change with the passage of time and may change because of revised estimates of cash flows or timing of cash flows. Such value changes shall be reported as bad debt expense in the same manner in which impairment initially was recognized or as a reduction in the amount of bad debt expense that would be A-13 reported. No interest income is accrued on impaired loans. Cash receipts on impaired loans are recorded as reductions of the principal amount. (l) Stock-Based Compensation As described in Note 11, we have elected to follow the accounting provisions of Accounting Principles Board Opinion (APBO) No. 25, Accounting for Stock Issued to Employees, for stock-based compensation and to furnish the pro forma disclosures required under SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. (m) Recently Issued Accounting Pronouncements Recently Issued Accounting Pronouncements In June 2001, FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The Company also records a corresponding asset that is depreciated over the life of the asset. Subsequent to the initial measurement of the asset retirement obligation, the obligation will be adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The Company is required to adopt SFAS No. 143 on January 1, 2003. The adoption of SFAS No. 143 is not expected to have a material effect on our consolidated financial statements. In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of the Statement related to the rescission of Statement No. 4 is applied in fiscal years beginning after May 15, 2002. Earlier application of these provisions is encouraged. The provisions of the Statement related to Statement No. 13 were effective for transactions occurring after May 15, 2002, with early application encouraged. The adoption of SFAS No. 145 is not expected to have a material effect on our consolidated financial statements. In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF)Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 is not expected to have a material effect on our consolidated financial statements. In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual A-14 financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and are not expected to have a material effect on our consolidated financial statements. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002. In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. This Statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements. In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51. This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to a variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. We have voluntarily elected early adoption of Interpretation No. 46. The effect of the application of this Interpretation is described in Note 14 to these consolidated financial statements. (n) Reclassification Certain reclassifications have been made to amounts presented in 2001 to be consistent with the 2002 presentation. (2) Management Fees and Other Receivables Management fees and other receivables consist of the following: December 31, 2002 2001 ---- ---- Management fees receivable $382,000 $30,000 Accrued interest receivable 91,000 4,000 Other receivables 290,000 450,000 ------- ------- $763,000 $484,000 ======== ======== We earn management fees by providing management services to American Physicians Insurance Exchange ("APIE") under the direction of APIE's Board of Directors. Subject to the direction of this Board, and subject to a management services agreement , FMI sells and issues policies, investigates, A-15 settles and defends claims, and otherwise manages APIE's affairs. We earned management fees and other related income of $9,455,000 and $7,263,000, including expense reimbursements, principally for our independent agents' commissions, of $3,368,000 and $2,570,000 for the years ended December 31, 2002 and 2001, respectively, related to these agreements. The summarized financial information for APIE as of and for the year ended December 31, 2002 and 2001 is as follows: 2002 2001 (unaudited) ----------- ----------- Current assets $67,129,000 $56,020,000 Long-term assets 13,592,000 8,537,000 ---------- ---------- Total assets 80,721,000 64,557,000 ========== ========== Current liabilites 67,736,000 53,082,000 Surplus 12,985,000 11,475,000 ---------- ---------- Total liabilities and surplus 80,721,000 64,557,000 ========== ========== Total revenue 29,556,000 35,892,000 Income from continuing operations 1,031,000 1,283,000 Net income 1,503,000 1,385,000 Trade accounts receivable are recorded at APS Consulting for services performed which are billed on a monthly basis. Other receivables in 2001 are primarily comprised of a non-interest bearing advance to APIE which was subsequently collected in March 2002. A-16 (3) Notes Receivable Notes receivable consist of the following: December 31, 2002 2001 ---- ---- FemPartners, Inc. (Formerly due from Syntera HealthCare Corporation) Promissory note, bears interest at 8%. Payments were interest only, paid quarterly through November 30, 2001. Quarterly combined principal and interest payments began December 1, 2001 and continue through September 1, 2004, at which time the total outstanding balance is due. The maturity date of this note can be accelerated if FemPartners conducts an initial public offering or other public sale of its common stock. If such occurs, the note shall mature and become due and payable on the 5th business day after the date of such initial public offering or other public sale. $902,000 $1,304,000 Unsecured term note, principal and interest, at 8%, payable monthly until maturity on March 31, 2004. 63,000 115,000 Employees Loans are periodically made to employees, primarily as employment retention inducements. Employee notes receivable at December 31, 2002 consisted of a note totaling $4,000 which will be amortized through 2004, provided the employee remains with us and two loans totaling $40,000 to a key employee for advanced education fees. The latter two notes are forgivable in the amount of approximately $13,000 on each January 1st that the employee is employed by the Company beginning in 2001 and continuing through 2005. They are due within 90 days should the employee terminate employment. Employee notes receivable at December 31, 2001 consisted of three notes totaling $100,000 which were repaid in full in February 2002 and two loans totaling $53,000 to a key employee for advanced education fees. The same terms apply as described above. 44,000 153,000 ------ -------- 1,009,000 1,572,000 Less current portion and allowance for doubtful accounts of $64,000 in 2002 (635,000) (573,000) -------- -------- Long term portion $374,000 $999,000 ======== ======== (4) Fair Value of Financial Instruments For financial instruments the estimated fair value equals the carrying value as presented in the consolidated balance sheets. Fair value estimates, methods, and assumptions are set forth below for our financial instruments. A-17 CASH AND CASH EQUIVALENTS The carrying amounts for cash and cash equivalents approximate fair value because they mature in less than 90 days and do not present unanticipated credit concerns. TRADING ACCOUNT SECURITIES The trading account securities owned are reported at fair value. In the absence of any available market quotation, securities held by us are valued at estimated fair value as determined by management. In addition to receiving commission revenue for acting as the placement agent for private offerings, APS Financial received over the past three years warrants to purchase a total of 652,351 shares of restricted common capital stock of four companies. The warrants expire in 2004 through 2007 and had no value at December 31, 2002. None of the warrants have been exercised as of December 31, 2002. AVAILABLE-FOR-SALE SECURITIES Available-for-sale securities owned are reported at fair value. ACCOUNTS RECEIVABLE The fair value of these receivables approximates the carrying value due to their short-term nature and historical collectibility MANAGEMENT FEES AND OTHER RECEIVABLEs The fair value of these receivables approximates the carrying value due to their short-term nature and historical collectibility. NOTES RECEIVABLE The fair value of notes has been determined using discounted cash flows based on our management's estimate of current interest rates for notes of similar credit quality. DEPOSIT WITH CLEARING ORGANIZATION The carrying amounts approximate fair value because the funds can be withdrawn on demand and there is no unanticipated credit concern. OTHER INVESTMENTS The fair value has been determined using a third party valuation. ACCOUNTS PAYABLE The fair value of the payable approximates carrying value due to the short-term nature of the obligation. A-18 LIMITATIONS Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. Fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the aforementioned estimates. (5) Marketable Securities At December 31, 2002, we have classified certain investments as available-for-sale. The cost, gross unrealized gains and losses, and fair value of these securities by major security type at December 31, 2002 was as follows: Gross Gross Unrealized Unrealized Fair Cost Gains Losses Value -------------------- ---------------- --------------- ---------------- -------------------- ---------------- ---------------- ---------------- U.S. government agencies $ 2,846,000 $ 60,000 $ -- $2,906,000 Corporate obligations 1,379,000 19,000 (16,000) 1,382,000 Equity securities 4,287,000 2,762,000 (53,000) 6,996,000 --------- --------- -------- --------- Total $8,512,000 $2,841,000 $(69,000) $11,284,000 ========== ========== ========= =========== Maturities of fixed income securities were as follows at December 31, 2002: Fair Cost Value --------------------- ---------------------- Due within one year $1,009,000 $1,015,000 Due after one year 3,216,000 3,273,000 --------- --------- Total $4,225,000 $4,288,000 ========== ========== Amounts reflected in the tables above include equity securities of Prime Medical with a fair value of $6,525,000 and corporate obligations of Prime Medical with a fair value of $860,000. (6) Property and Equipment Property and equipment consists of the following: December 31, ----------------------------- 2002 2001 ---- ---- Equipment $1,150,000 $1,076,000 Furniture 642,000 630,000 Software 319,000 281,000 Leasehold improvements 240,000 234,000 ----------- ----------- $2,351,000 $2,221,000 Accumulated depreciation and amortization (1,977,000) (1,806,000) ----------- ----------- $374,000 $ 415,000 =========== ========== A-19 (7) Accrued Expenses and Other Liabilities Accrued expenses and other liabilities consists of the following as of December 31,: 2002 2001 ---- ---- Commissions payable $ 798,000 $ 533,000 Taxes payable 93,000 61,000 Contractual/legal claims -- 1,031,000 Vacation payable 154,000 140,000 Other 182,000 105,000 -------- -------- $1,227,000 $1,870,000 ========== ========== Contractual/legal claims as of December 31, 2001 includes an accrual of $520,000 related to the settlement of a legal judgment against us that was paid in January 2002. Prior to the negotiated settlement of the judgment, we were required to put up a cash bond in the amount of the original judgment in the amount of $762,000. As of December 31, 2001, this amount was reflected in the line item "Prepaid expenses and other" in the accompanying consolidated balance sheet. The difference between the cash bond and the settlement amount was reimbursed to us in February 2002. Also in 2001, we recorded a liability of $511,000 for agreements with former doctor shareholders of Syntera, a practice management company we owned that was merged with FemPartners. Under the agreement, we agreed to exchange their shares in Syntera for the common stock of American Physicians, or cash, if the Syntera shares did not become publicly traded. In 2002 we paid cash to settle this liability, thus satisfying all obligations. (8) Notes Payable We had a $7,500,000 line of credit with Bank of America, N. A. We had pledged substantially all of the assets of our subsidiaries as well as shares of Prime Medical to the bank as funds were advanced under the line. Funds advanced under the agreement were $2,275,000 at December 31, 2001. Funds advanced under the agreement bore interest at the prime rate less 25 basis points. Interest expense incurred during the years ended December 31, 2002 and 2001 related to the line of credit was approximately $8,000 and $388,000 respectively. All amounts payable under the line of credit were due February 2003 but were repaid in February 2002. We terminated the line of credit during 2002. (9) Commitments and Contingencies Expenses under all operating leases for the years ended December 31, 2002 and 2001 were $1,077,000 and $534,000, respectively. Future minimum payments for leases that extend for more than one year through 2007 were $950,000; $825,000; $687,000; $487,000 and $8,000 for 2003, 2004, 2005, 2006 and 2007, respectively. We have extended various lines of credit to Uncommon Care. See Note 15 to these consolidated financial statements. We have extended a line of credit to APS Consulting. See Note 14 to these consolidated financial statements. A-20 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 consolidated financial condition or results of operations. We guaranteed a loan in the maximum amount of $70,000 for a director, William Searles. The guarantee was collateralized by Mr. Searles' options to purchase American Physicians and Prime Medical shares as well as Mr. Searles' common stock interest in Uncommon Care. At December 31, 2001 the loan was in the amount of $35,000. The loan was paid in full subsequent to year end. Following the passage of the Sarbanes/Oxley Act in July, 2002, all officers and directors were informed that loans, advances or guarantees would no longer be permitted. (10) Income Taxes Income tax expense (benefit) consists of the following: Year Ended December 31, -------------------------- 2002 2001 ---- ---- Continuing Operations Federal Current $2,471,000 $(694,000) Deferred (151,000) (330,000) State-Current 95,000 72,000 ----------- ---------- Total from Continuing Operations 2,415,000 (952,000) Discontinued Operations -- 727,000 ----------- ---------- $2,415,000 $(225,000) =========== ========== A reconciliation of expected income tax expense (benefit) computed by applying the United States federal statutory income tax rate of 34% to earnings (loss) from continuing operations before income taxes to tax expense (benefit) from continuing operations in the accompanying consolidated statements of operations follows: Year Ended December 31, -------------------------- 2002 2001 ---- ---- Expected federal income tax expense (benefit) from continuing operations $1,981,000 $(1,001,000) State taxes 63,000 48,000 Goodwill adjustment 214,000 -- Minority interest 89,000 -- Other, net 68,000 1,000 --------- ----------- $2,415,000 $ (952,000) ========== =========== A-21 The tax effect of temporary differences that gives rise to significant portions of deferred tax assets and deferred tax liabilities at December 31, 2002 and 2001 are presented below: Year Ended December 31, --- 2002 2001 ---- ---- Deferred tax assets: Net operating loss carryforwards $ -- $ 110,000 Accrued expenses 101,000 227,000 Allowance for doubtful accounts 68,000 16,000 Investment in available-for-sale securities and equity investees 1,444,000 -- Other investments 51,000 919,000 Sales/Leaseback deferred income 732,000 1,073,000 Other 3,000 84,000 ---------- ---------- Total gross deferred tax assets 2,399,000 2,429,000 Less valuation allowance -- (110,000) ---------- ---------- Deferred tax assets-net of valuation allowance 2,399,000 2,319,000 --------- ---------- Deferred tax liabilities: Investment in equity investments due to use of equity method for financialreporting -- (528,000) Market value allowance on investments (943,000) -- Deferred income for tax purposes -- (26,000) Capitalized expenses, principally due to deductibility for tax purposes (31,000) (32,000) -------- --------- Total gross deferred tax liabilities (974,000) (586,000) --------- --------- Net deferred tax asset $1,425,000 $1,733,000 ========= ========= The net change in the total valuation allowance for the year ended December 31, 2002 was a decrease of $110,000. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2002. (11) Employee Benefit Plans We have an employee benefit plan qualifying under Section 401(k) of the Internal Revenue Code for all eligible employees. Employees become eligible upon meeting certain service and age requirements. Employee deferrals may not exceed $11,000 in 2002 unless participant is over age 50, in which case the maximum deferral is $12,000. We may, at our discretion, contribute up to 200% of the employees' deferred amount. A-22 For the years ended December 31, 2002 and 2001, our contributions aggregated $135,000 and $88,000, respectively. (12) Stock Options We have adopted, with shareholder approval, the "1995 Non-Employee Directors Stock Option Plan" ("Directors Plan") and the "1995 Incentive and Non-Qualified Stock Option Plan" ("Incentive Plan"). The Directors Plan provides for the issuance of up to 200,000 shares of common stock to non-employee directors who serve on the Compensation Committee. The Directors Plan is inactive and it is assumed the remaining 170,000 shares will not be granted. The Incentive Plan, as amended with shareholder approval in 1998, 2001, and 2002 provides for the issuance of up to 1,600,000 shares of common stock to our directors and key employees. A total of 952,000 of these options have been granted as of December 31, 2002. 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 substantially all outstanding options vest in two or three approximately equal annual installments beginning one year from the date of grant. We have adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("Statement 123"), but apply Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, in accounting for our stock option plans. In 2002 we purchased 89,000 unexpired options from four grantees. These purchases modified the terms of the options and we recognized $156,000 of compensation expense, as a result. Except as previously noted, no compensation expense from stock-based compensation awards was recognized in 2002 or 2001. If we had elected to recognize compensation expense for options granted based on the fair value at the grant dates, consistent with Statement 123, net income and earnings per share would have changed to the pro forma amounts indicated below: Year Ended December 31, --- 2002 2001 Net income (loss) as reported $3,411,000 $ (578,000) Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (222,000) (226,000) ---------- --------- Pro forma net income (loss) $3,189,000 $(804,000) ========== ========= Income (loss) per share Basic - as reported $1.53 $(0.25) ===== ======= Basic - pro forma $1.43 $(0.34) ===== ======= Diluted - as reported $1.45 $(0.25) ===== ======= Diluted - pro forma $1.36 $(0.34) ===== ======= A-23 The fair value of the options used to compute the pro forma amounts is estimated using the Black Scholes option-pricing model with the following assumptions: 2002 2001 ----- ----- Risk-free interest rate 3.4% 4.45% Expected holding period 3.7 years 3.90 years Expected volatility .477 .798 Expected dividend yield -0- -0- Presented below is a summary of the stock options held by our employees and our directors and the related transactions for the years ended December 31, 2002 and 2001. Year Ended December 31, --- 2002 2001 ---------------------- ------------------------- Weighted Weighted Average Average Exercise Exercise Shares Price Shares Price ------- --------- ---------- ---------- Balance at January 1 788,000 $3.45 1,151,000 $5.04 Options granted 305,000 3.72 134,000 2.25 Options exercised (13,000) 1.69 -- -- Options repurchased (89,000) 2.38 -- -- Options forfeited/expired (52,000) 6.26 (497,000) 6.70 -------- --------- Balance at December 31 939,000 3.51 788,000 3.45 ======= ---- ======= ==== Options exercisable 500,000 3.78 455,000 4.19 ======= ==== ======= ==== The weighted average fair value (the theoretical option value calculated using the Black Scholes option pricing model) of Company stock options granted during the years ended December 31, 2002 and 2001 is $1.46 and $1.36 per option, respectively. In this case, as of December 31, 2002, weighted average price per share of Company stock options ($5.18) less the weighted average exercise price of options granted ($3.72) equals the weighted average fair value of options granted ($1.46). The following table summarizes the Company's options outstanding and exercisable options at December 31, 2002: Stock Options Stock Options Outstanding Exercisable -- ----------------------------------- Average Weighted Weighted Remaining Average Average Range of Contractual Exercise Exercise Exercise Prices Shares Life Price Shares Price -------------- ------ ---- ----- ------ ----- $1.50 to $3.50 237,000 3.1 years $1.94 101,000 $1.80 $3.51 to $5.50 675,000 2.5 years $3.91 372,000 $4.08 $5.51 to $7.25 27,000 0.3 years $7.18 27,000 $7.18 ------- ------- Total 939,000 500,000 ======= ======= A-24 (13) Discontinued

Operations Summary operating data for APS Realty is as follows: Year Ended December 31, 2002 2001 ----- ---- Rent revenues -- $ 677 Expenses -- 467 Gain on building sale -- 1,927 ----- ------- Income before taxes -- $2,137 Income tax expense 727 ----- ------- Net Income -- $1,410 ===== ======= In November, 2001 we sold all of the remaining 46,000 square feet of condominium space we owned in an office project located in Austin, Texas to our former affiliate, Prime Medical. In conjunction with the sale we leased back approximately 23,000 square feet that housed our operations prior to the sale. Our wholly-owned subsidiary, APS Realty, which formerly owned this office space and leased space to us, our subsidiaries, affiliates and unaffiliated parties, was subsequently dissolved. As a result there are no corresponding assets or liabilities related to discontinued operations as of December 31, 2001. Gain on the sale amounted to approximately $5.1 million, of which $1.9 million was recognized in 2001 and the balance of the gain was deferred. Deferred income of approximately $2.4 million related to our continuing involvement in 50% of the usable space was recorded and is being recognized monthly over the five year lease term through November 2006. Income recognition related to this deferral was $488,000 in 2002 and $41,000 in 2001. In addition, 15% of the gain ($0.76 million) related to our 15% ownership in the purchaser, was deferred as we accounted for Prime Medical using the equity method of accounting through the year ended December 31, 2001. During 2002 we reduced our investment in Prime Medical and subsequently recognized a proportionate percentage of the deferred gain, or about $515,000. Recognition of the deferred gain is recorded as a reduction of rent expense in operating expenses in the accompanying financial statements. (14) Sale of APS Consulting Effective November 1, 2002, we completed the sale of APS Consulting to its management. We sold all of our APS Consulting shares for a de minimus amount of cash plus a $250,000 seven year term note at the prime rate plus 3%. The note is secured by the assets of APS Consulting. Our existing contract to provide administrative support services to APS Consulting for a period of approximately seven years remains in effect. Fees under this contract are dependent on APS Consulting's pre-tax earnings but may not be less than $200,000 or more than $518,000 over its remaining term. In addition, we extended a line of credit to APS Consulting of up to $450,000. This line is at the prime rate plus 3% and is collateralized by the accounts receivable and cash of APS Consulting. Advances under the line are dependent upon meeting borrowing base requirements. Under the terms of the sale agreement, we are dependent upon the future successful operation of the division to collect our proceeds from the disposal. Additionally, as we have a security interest in the assets of the division, we have retained a risk of loss on the division's assets and, under the terms of our notes with the division, we have the ability to veto certain transactions, including significant asset disposals. A-25 Consistent with the guidance under FIN 46, we have not recognized the divestiture of APS Consulting and continue to consolidate the division as an entity in which we have a variable interest that will absorb the majority of the entity's operating losses if they occur. Accordingly, the assets and liabilities are included in our consolidated balance sheet as of December 31, 2002. The balance sheet below summarizes the assets and liabilities of APS Consulting that are included in our consolidated balance sheet at December 31, 2002: 2002 ------- Assets Cash $347,000 Accounts Receivable, net 409,000 Prepaid Expenses 22,000 ------ Total Current Assets 778,000 Property and Equipment 45,000 ------ Total Assets $823,000 ======== Liabilities Accounts Payable $445,000 Accrued Expenses 74,000 -------- Total Current Liabilites 519,000 Notes Payable 248,000 Deferred Income 74,000 -------- Total Liabilites $841,000 ======== Total Liabilities in excess of Assets $ 18,000 ========= The revenues and expenses of APS Consulting from January 1, 2002 through the date of sale, November 1, 2002, have been included in our consolidated financial statements for the year ended December 31, 2002. In addition, we continue to recognize APS Consulting's revenues and expenses subsequent to the sale. If, subsequent to the sale, APS Consulting reports operating losses, we record such losses in our statement of operations. If APS Consulting reports net earnings, we reduce our interest in such earnings to zero by increasing the minority interest presented in our statement of operations. The statement of operations below summarizes the results of APS Consulting that are included in our consolidated statement of operations for the year ended December 31, 2002: A-26 Pre- Post- Transaction Transaction Total ----------- ----------- ----------- Consulting Revenue $2,790,000 $506,000 $3,296.000 Consulting Expenses 2,403,000 506,000 2,909,000 --------- ------- --------- Operating Income $ 387,000 $ -- $ 387,000 ========= ========= ========= Creditors of APS Consulting have no recourse to the general credit of the Company or its other consolidated subsidiaries. (15) Investment in Unconsolidated Affiliates As of December 31, 2002 and 2001, respectively, our investment in unconsolidated affiliates consisted of the following: December 31, 2002 2001 ------ -------- Prime Medical Services, Inc. $ -- $ 10,700,000 Uncommon Care $ -- $ -- ------ ----------- $ -- $ 10,700,000 For the year ended December 31, 2002 and 2001, respectively, our equity in the loss of unconsolidated affiliates consisted of the following: December 31, 2002 2001 ------- -------- Prime Medical Services, Inc. $ 186,000 $(2,179,000) Uncommon Care $(230,000) $(1,012,000) ---------- ----------- $ (44,000) $(3,191,000) A-27 On October 12, 1989, we purchased 3,540,000 shares (42%) of the common stock of Prime Medical. Prime Medical is the largest provider of lithotripsy (a non-invasive method of treating kidney stones) services in the United States and is an international supplier of specialty vehicles for the transport of high technology medical and broadcast/communications equipment. In the ensuing years, the sale of stock, stock exchanges and stock issuances reduced our ownership and at December 31, 2001 our holdings stood at 2,344,000 shares or approximately 15% of the common stock. During this period we accounted for our investment using the equity method, as we exercised significant influence over operating and financial policies. In the first quarter of 2002, with the sale of Prime Medical shares reducing our ownership to less than 5%, and our chairman and CEO reducing his responsibilities on Prime's Board, we began to account for our Prime Medical investment as an available-for-sale equity security. In connection with the sales of primes shares during the year, we recognized a gain of $2,855,000. The gain is classified as "Gain on Sale of Investments" in the accompanying consolidated financial statements. Changes in market value of our Prime Medical shares are included in shareholders equity as "accumulated other comprehensive income". Prime is an SEC registrant and additional information on the company can be found on the SEC's web site at www.sec.gov. The condensed balance sheet and statement of operations for Prime Medical follows (unaudited, in thousands): Condensed balance sheet at December 31, 2001: 2001 ------------ Current assets $ 59,213 Long-term assets 192,828 --------- Total assets $252,041 ========= Current liabilities $ 28,350 Long-term liabilities 138,215 Shareholders' equity 85,476 --------- Total liabilities and equity $ 252,041 ========== Condensed statement of operations for the years ended December 31, 2001: 2001 ---------- Total revenue $ 154,868 ========== Net income (loss) $ (14,465) ========== A-28 On January 1, 1998 we invested approximately $2,078,000 in the convertible preferred stock of Uncommon Care and have extended three lines of credit totaling $4,850,000. At December 31, 2002, a total of $4,605,000 was drawn upon these lines. Uncommon Care is a developer and operator of dedicated Alzheimer's care facilities. The preferred shares we own are convertible into approximately a 29% common stock interest in the equity of Uncommon Care on a fully converted basis. In 2002 and 2001 we received common shares amounting to an additional 13% common stock interest as payment in kind for interest on our lines of credit. Our investment entitles us to vote in certain instances and to elect one of the four members of the board of directors of Uncommon Care. In addition, pursuant to a shareholders agreement between Uncommon Care and its shareholders, one of the directors elected by the holders of the preferred stock must consent to Uncommon Care's taking certain important corporate actions specified in the shareholders agreement. The lines of credit extended to Uncommon Care was their sole source of liquidity during 2002. We believe our 42% ownership creates significant influence over Uncommon Care and accordingly we apply the equity method in accounting. Amounts outstanding under lines of credit extended to Uncommon Care at December 31, 2002 and 2001 are as follows (in thousands): 2002 2001 ----- ----- Revolving Line of Credit: This note is unsecured with a maximum of $1,200,000. The note is interest only at 10%, payable semi-annually. The note matured September 30, 2001, but was extended until April 30, 2003. Maturity may be accelerated if the borrower obtains specific levels of equity financing. The borrower may at that time pay off the loan in full or convert it into non-voting preferred stock of the borrower. In the event of non-payment at maturity, the lender may elect to convert the outstanding balance into capital stock of the borrower. $955 $810 Revolving Line of Credit: This note is unsecured with a maximum of $1,250,000. The note is interest only at 12%, payable semi-annually. The note matured April 30, 2000, but was extended until April 30, 2003. Maturity may be accelerated if the borrower obtains specific levels of equity financing. The borrower may at that time pay off the loan in full or convert it into non-voting preferred stock of the borrower. In the event of non-payment at maturity, the lender may elect to convert the outstanding balance into $1,250 $1,250 capital stock of the borrower. Revolving Line of Credit: This note is secured by substantially all of the assets of borrower and is subordinated to bank loans for various real estate purchases. The maximum allowed on this note is $2,400,000. This note is interest only at 10%, payable quarterly. Any outstanding principal is due June 30, 2005. $2,400 $2,400 During 2002 we agreed to modify the terms of the foregoing notes. For the period July 1, 2001 through June 30, 2002 the interest rate was changed to 4% and payments were paid in-kind (PIK) in the form of Uncommon Care common stock at $0.57 per share. Additionally, the PIK stock may be repurchased by Uncommon Care through June 30, 2004 at a price of $.64 per share. We agreed to these modified terms to improve Uncommon Care's liquidity and to assist it in complying with the terms of its bank covenants. PIK payments during 2002 and 2001 increased our ownership in Uncommon Care from 34% to 42% on a fully converted basis. A-29 Following the expiration of the PIK agreement Uncommon Care did not resume paying interest to us and is in default on the three notes. Our options for collecting this debt are restricted by the terms of a subordination agreement entered into with Uncommon Care's senior leader. Some of our officers and directors participated in the $2,400,000 line of credit to Uncommon Care. For financial purposes this participation has been treated as a secured borrowing. In the aggregate, these officers and directors contributed approximately $259,000 to fund a 10.8% interest in the loan. They participate in the loan under the same terms as the Company. We have applied the guidance of EITF 99-10, specifically the percentage of ownership method, in applying the quity method to our investment in Uncommon Care. Uncommon Care's common stock equity had been eliminated by losses prior to our investment and, accordingly, we have recognized 100% of the losses of Uncommon Care, to the extent of our investment, based on our ownership of 100% of Uncommon Care's preferred stock equity and subordinated debt with Uncommon Care. During 2001 our total bases in investment and advances to Uncommon Care was reduced to zero. During 2002 we expensed the $230,000 which we advanced under the lines of credit. As this advance represented a funding of Uncommon Care's prior losses, the amount was expensed when advanced and is included in the equity in loss related to this affiliate. Repayments on the line of credit during 2002 were $85,000 and were recorded as deferred income. At December 31, 2002, Uncommon Care was not in compliance with its senior loan covenants. Uncommon Care's senior lender has several options ranging from renegotiating new loan terms to seizing its collateral, thus forcing Uncommon Care in bankruptcy. It is unknown as of the date of this report what action the lender may take. The condensed balance sheet and statement of operations for Uncommon Care follows (unaudited, in thousands): Condensed balance sheet at December 31, 2001: 2001 ---------- Current assets $148 Long-term assets 14,544 ------ Total assets $14,692 ======= Current liabilities $ 1,051 Long-term liabilities 18,502 Shareholders' deficit (4,861) -------- Total liabilities and equity $14,692 ======== Condensed statement of operations for the years ended December 31, 2001: 2001 ---------- Total revenue $ 6,550 ======= Net loss $(1,440) ========= A-30 (16) Segment Information Our segments are distinct by type of service provided. Each segment has its own management team and separate financial reporting. Our Chief Executive Officer allocates resources and provides overall management based on the segments' financial results. Our financial services segment includes brokerage and asset management services to individuals and institutions. Our insurance services segment includes financial management for an insurance company that provides professional liability insurance to doctors. Our consulting segment includes environmental consulting and engineering services to private and public institutions. Corporate is the parent company and derives its income from interest and investments. Income from the discontinued real estate segment was derived from the leasing of and sale of office space. 2002 2001 ---- ---- Operating Revenues: Financial services $13,625,000 $13,094,000 Insurance services 9,455,000 7,263,000 Consulting 3,296,000 2,642,000 Other 1,081,000 3,992,000 --------- --------- $27,457,000 $26,991,000 Reconciliation to Consolidated Statements of Operations: Total segment revenues $27,457,000 $26,991,000 Less: intercompany dividends (1,024,000) (3,951,000) intercompany interest (41,000) (41,000) ---------- ---------- Total Revenues $26,392,000 $22,999,000 =========== =========== Operating Income (Loss): Financial services $1,749,000 $1,576,000 Insurance services 2,389,000 1,345,000 Consulting 387,000 (379,000) Corporate 2,202,000 --------- ---------- (355,000) $4,170,000 $4,744,000 Reconciliation to Consolidated Statements of Operations: Total segment operating profit $4,170,000 $4,744,000 Intercompany interest (41,000) (41,000) Less: intercompany dividends (1,024,000) (3,951,000) ---------- ---------- Operating income $3,105,000 $752,000 Gain on sale of investments 2,855,000 -- --------- ----------- Profit (loss)from continuing operations before interest, income taxes, minority interests and equity in loss of unconsolidated affiliates 5,960,000 752,000 Interest Income 195,000 121,000 Interest expense 24,000 465,000 Income tax expense (benefit) 2,415,000 (952,000) Minority interests 261,000 157,000 Equity in loss of affiliates (44,000) (3,191,000) --------- --------- Profit(loss) from continuing operations 3,411,000 (1,988,000) Net profit from discontinued operations, net of income tax -- 1,410,000 ---------- ----------- Net earnings (loss) $3,411,000 $ (578,000) ========= =========== A-31 2002 2001 ---- ---- Identifiable assets: Financial Services $3,727,000 $3,540,000 Insurance Services 2,882,000 1,620,000 Consulting 823,000 738,000 Corporate: Investment in and advances to equity method investees -- 10,700,000 Investment in available for sale securities 11,284,000 -- Other 6,265,000 5,062,000 --------- --------- $24,981,000 $21,660,000 ========= ========= Capital expenditures: Financial Services $24,000 $43,000 Insurance Services 78,000 48,000 Consulting 15,000 20,000 Corporate 37,000 81,000 ------ ------ $154,000 $192,000 ======== ======== Depreciation/amortization expenses: Financial Services $42,000 $45,000 Insurance Services 55,000 57,000 Consulting 18,000 75,000 Corporate 73,000 68,000 Discontinued Operations -- 67,000 --------- -------- $188,000 $312,000 ========= ======== Revenues attributable to customers generating greater than 10% of the consolidated revenues of the Company: Insurance services Company A $3,320,000 Less than 10% At December 31, 2002 we had long-term contracts with company A and were therefore not vulnerable to the risk of a near-term severe impact from a reasonably possible loss of the revenue. However, should Company A default or be unable to satisfy its contractual obligations, there would be a material adverse effect on our financial condition and results of operations. Operating profit (loss) is operating revenues less related expenses and is all derived from domestic operations. Identifiable assets are those assets that are used in the operations of each business segment (after elimination of investments in other segments). Corporate assets consist primarily of cash and cash equivalents, notes receivable, investments in available-for-sale securities and investments in affiliates. A-32 (17) Earnings Per Share Basic earnings per share are based on the weighted average shares outstanding without any dilutive effects considered. Diluted earnings per share reflects dilution from all contingently issuable shares, including options. A reconciliation of income and average shares outstanding used in the calculation of basic and diluted earnings per share from continuing and discontinued operations follows: For the Year Ended December 31, 2002 ---------------------------------- Income Shares Per-Share (Numerator) (Denominator) Amount ---------- ------------ ---------- Earnings from continuing operations $3,411,000 Discontinued operations, net of tax -- Basic EPS: Earnings available to common stockholders 3,411,000 2,227,000 $1.53 ===== Effect of dilutive securities 118,000 --------- --------- Diluted EPS: Earnings available to common stockholders 3,411,000 2,345,000 $1.45 ========= ========= ===== For the Year Ended December 31, 2001 ----------------------------------- Income Shares Per-Share (Numerator) (Denominator) Amount ---------- ------------ ---------- Loss from continuing operations $(1,988,000) Discontinued operations, net of tax 1,410,000 Basic EPS: Loss available to common stockholders (578,000) 2,343,000 $(0.25) ======= Effect of dilutive securities -- -- --------- ---------- Diluted EPS: Loss available to common stockholders $ (578,000) 2,343,000 $(0.25) ========= ========= ======= Unexercised employee stock options to purchase 432,000 and 788,000 shares of our common stock for the years ended December 31, 2002 and 2001, respectively, were not included in the computations of diluted EPS because their effect would be antidilutive. A-33 (18) Other Investments Other investments consisted of an investment in FemPartners, Inc. totaling $68,000 at December 31, 2001. This investment was marketed extensively in 2002 and was sold for the best offer, $8,000, to a former officer. (19) Shareholders' Equity The following table presents changes in shares outstanding for the period from December 31, 2000 to December 31, 2002: Common Shares Treasury Outstanding Stock ------------ ------------ Balance December 31, 2000 2,745,231 386,000 Treasury stock purchases and retirement -- -- ----------- ----------- Balance December 31, 2001 2,745,231 386,000 Options Exercised 13,000 -- Treasury stock purchases -- 238,388 Treasury stock retirements (624,388) (624,388) ---------- ---------- Balance December 31, 2002 2,133,843 -- ========== ========== (20) Goodwill We recorded goodwill in connection with our acquisition of Eco-Systems, in 1999. During 2001, we recognized $51,000 in amortization expense related to the goodwill. In accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, we assessed the goodwill for impairment in 2001. As of December 31, 2001, the review indicated that the goodwill was impaired and an impairment charge of $391,000 was recorded to write off the remaining unamortized amount. No goodwill was recorded as of December 31, 2001 and 2002. (21) Quarterly Results (Unaudited) Quarter to quarter comparisons of results of operations have been and may be materially impacted by bond market conditions and whether or not there are profits at the medical malpractice insurance company which we manage and whose profits we share. We believe that the historical pattern of quarterly sales and income as a percentage of the annual total may not be indicative of the pattern in future years. The following tables set forth selected quarterly consolidated statements of operations information for the years ended December 31, 2002 and 2001: A-34 (In thousands, except per share data) First Second Third Fourth Quarter Quarter Quarter Quarter 2002 ------- ------- ------- ------- Revenues $5,939 $6,353 $7,241 $ 6,859 Net earnings 2,602 449 296 64 Basic earnings per share: Net earnings $1.12 $0.20 $0.13 $ 0.03 Diluted earnings per share: Net earnings $1.07 $0.19 $0.13 $ 0.03 2001 Revenues $5,588 $5,995 $6,268 $ 5,148 Earnings (loss) from continuing operations 84 251 82 (2,405) Discontinued operations, net of taxes 41 34 35 1,300 Net earnings (loss) $125 $285 $117 $(1,105) Basic earnings (loss) per share: From continuing operations $0.04 $0.11 $0.03 $(1.03) Discontinued operations, net of taxes 0.02 0.01 0.01 0.55 Net earnings (loss) $0.05 $0.12 $0.05 $(0.47) Diluted earnings (loss) per share: From continuing operations $0.03 $0.09 $0.03 $(1.03) Discontinued operations, net of taxes 0.01 0.01 0.01 0.55 Net earnings (loss) $0.05 $0.10 $0.04 $(0.47) Results for the first quarter of 2002 include gains on the sale of 1,570,000 shares of Prime Medical common stock totaling $2,802,000 pre-tax. In connection with these sales, we also recognized a portion of the $760,000 gain on sale of real estate related to our 15% interest in Prime.

Such gains recognized in the first quarter were approximately $500,000. Results for the fourth quarter of 2002 include an adjustment A-35 increasing federal income tax expense by $214,000. This adjustment represents a one-time tax adjustment relating to APS Consulting. (22) Concentration of credit risk Marketable securities As of December 31, 2002 we owned marketable securities of Prime Medical with a fair market value of $7,385,000, or approximately 30% of our total assets. An event having a material adverse effect on Prime Medical and resulting in a devaluation of their securities would also have a material adverse effect on our financial condition and results of operations. Geographic concentration of insurance services Most of the managed insurance company's business is concentrated in Texas. Regulatory or judicial actions in that state that affected rates, competition, or tort law could have a significant impact on the insurance company's business. Consequently, our insurance management business, which is based on the premiums and profitability of the managed company, could be adversely affected. Financial market concentration of investment services Investment Services derives most of its revenue through commissions earned on the trading of fixed-income securities. Should conditions reduce the market's demand for fixed-income products, and should Investment Services be unable to shift it emphasis to other financial products, it could have a material adverse impact on our financial condition and results of operations.